THE CIVIL CODE - PROPOSED AMENDMENTS ON SECURED TRANSACTIONS

I. Introduction

During a recent World Bank Group (WBG) Mission to Chisinau (March 26-30, 2018), the Ministry of Justice informed the WBG that, in the context of the upcoming amendments to the Civil Code, the Law on Pledge would be integrated into the Code and the standalone legislation repealed. Anecdotal evidence from local stakeholders indicates that the proposed amendments to the Civil Code will be sent to Parliament before the summer of 2018.

Some of these amendments are not in line with international good practice and, in fact, reverse reforms adopted in 2014 that were supported by Bank technical assistance and a Development Policy Operation (DPO), which is particularly concerning for the WBG.

This note provides a review and analysis of selected articles relating to the Pledge provisions proposed as amendments to the Civil Code (the “Draft”). A full version of the proposed amendments was not available in English. Therefore, the comments below should be seen only as commentary on the current Draft and not as a comprehensive analysis. This note discusses issues raised by specific provisions of the Draft and highlights other provisions that may reverse reforms adopted in 2014.

While the comments below focus on the substance of provisions in the Draft, we emphasize here our preference that issues with the current legal and institutional framework for the Law on Pledge, which is not fully functional, be resolved and that it operate as intended before its provisions are integrated into the Civil Code.

Our commentary contains preliminary observations that are subject to input from and consultation with local experts. The UNCITRAL’s Legislative Guide on Secured Transactions (2010) (the “Guide”), and its Model Law on Secured Transactions (2016) (the “Model Law”), together with the World Bank’s Principles for Effective Insolvency and Creditor/Debtor Regimes, are the applicable standards used to assess the Draft.

II. Comments

A) Source for Rights and Obligations

Before commenting on the proposed amendments, there is one article that should be inserted in the Draft. It is not in the current version of the Law on Pledge. Nor was it in the 2001 Law.

In a notice-filing legal framework, like the one existing in Moldova today, the source of the rights and obligations between the parties is the pledge agreement. The registration system contains very basic information only, and this is on purpose.

Notice-filing models of registry systems function like a directory service. They contain skeletal information in each record: debtor and secured party’s names and addresses, type of collateral secured, period of the registration and maximum amount secured. Once that information is
obtained, a searcher who wishes to obtain information contained in the pledge agreement is directed to the creditor of record.

International standards require provisions in the legal framework authorizing an interested party to request a statement of account from a creditor of record and obliging that creditor to respond accordingly. This establishes a functional connection between the pledge agreement and a registered notice. By exercising their rights under provisions of that nature in a functional notice-based registry system, a searcher or an interested party gains access to detailed information contained in the pledge agreement. As noted, a functioning notice-based registry system should not contain a copy of the security agreement, nor should it provide a summary of the terms of the agreement beyond the skeletal information.

In contrast, the registry system in Moldova is conceptually treated by local stakeholders as the source of the rights and obligations of the parties, as though it were a traditional registry of immovable property interests. Current practice in Moldova is to insert the specifics of the collateral in the registry database. That is a very tedious and time-consuming process, especially where the collateral involves a revolving pool of assets, such as inventory. This practice contradicts the principles contained in Article 37 of the Law on Pledge: “The Register of Real Guarantees shall be designed to ensure that the registration and searching processes are simple, efficient, publicly-accessible and transparent.”

To counteract the practice of using the registry as the only source of valid information regarding the pledge, we recommend that the following or similar wording should be inserted in the proposed amendments:

“The security agreement is the source of the rights and obligations of the parties to the agreement and once published, it is effective according to its terms between the parties to it, and against third parties.”

This concept is implicit in several articles in the Law on Pledge – for example, Articles 13-15; and 24-27. However, given current practice in Moldova, it should be expressly stated rather than implied.

B) **The right of the debtor to receive a statement of account and list of pledged assets**

As noted, the pledge agreement is the source of rights and obligations between the parties. The notice-based registry provides minimal information to a searcher, and with this information the registry system directs a searcher to the registered creditor, should the searcher wish to obtain more details.

To do this, all notice-based systems contain provisions in the legal framework that provide a debtor the right, upon request, to receive a statement of account and detailed information about the assets pledged, as contained in the security agreement. A provision of this nature should be included in the Draft.
The provision should grant that right only to the debtor. In practice, the searcher makes the inquiry on behalf of the debtor, by executing a short agency agreement or power of attorney. The recipient of such request should be obliged to respond.

Accordingly, we recommend that the following or similar wording should be inserted in the proposed amendments:

**Statements of account**

1. **Within 10 days after receipt of a written request by a grantor, a secured creditor other than a transferee under an outright transfer of a receivable by agreement must send to the grantor at the address specified in the request:**
   - (a) A statement of the obligation currently secured; and
   - (b) A description of the assets currently encumbered.

2. **The grantor is entitled without charge to one response to a request within a period of [e.g. 12 months].**

3. **The secured creditor may require payment of a charge not exceeding [e.g. 2000 Leu] for each additional response.**

(Source: UNCITRAL Model Law)

**C) Guarantees in writing**

Proposed Article 455(1) provides: *"The debtor and the pledge guarantor may, in their capacity as pledger, agree on the conditions for guaranteeing the debtor's performance by the pledge guarantor, as well as the debtor's obligations towards the pledge guarantor in the event of the exercising of the right of pledge by the pledgee. The lack of such written agreement does not affect the validity of the pledge."*

The concern in this instance is with reference to the last sentence in this provision. Best practice invariably requires guarantees to be in writing, and this is the case in Moldova. However, the last sentence creates some ambiguity and uncertainty, at least in translation. We understand that the last sentence refers to the lack of a written agreement between the debtor and a pledge guarantor.

Accordingly, consider clarifying the last sentence. For example: *"The lack of a written agreement between the debtor and the pledge guarantor does not affect the validity of the guarantor’s pledge."*

**D) The maximum amount secured.**

Proposed Article 468.4(3) provides that: *"The pledge shall also extend to the payment of interest, fees, penalties, fines, indemnification for damage caused, compensation of court costs, maintenance costs of pledged assets and other pledge enforcement expenses, unless otherwise agreed by the parties."*
This Article provides that the pledge extends to a broad list of items, some of which relate to the loan. While we have no objection in principle to this list, we note that it combines claims that relate to execution of the pledge right with claims that arise from the pledge agreement.

Costs and expenses that relate to the repossession, repair, maintenance and disposition of collateral benefit all creditors. They are fixed costs that must be incurred before any creditor can benefit from their rights against a debtor’s assets. In contrast, a claim for principal and interest, and any other claims that might exist, are unique to the parties, and flow from the pledge agreement. Accordingly, we would suggest that the article separates these claims within Article 468.4(3).

Because expenses incurred in the retaking, holding, repairing, processing and preparing for disposition, and disposing of the collateral relate to the execution of the pledge right, these costs and expenses are appropriate statutory claims against a debtor’s assets, whether they are mentioned in a pledge agreement or not. They clearly benefit the enforcing creditor; they benefit subsequent creditors to the extent that there is a surplus that will extinguish their claims, after the seizing creditor’s claims are satisfied; and the debtor benefits to the extent that their obligations are extinguished, assuming there is no deficiency. Therefore, these costs and expenses should be deducted before any consensual claims are satisfied.

We have one observation to make in respect of claims and expenses. Consider adding the word “reasonable” to this list of costs and expenses, to avoid the moral hazard created by seizing parties incurring unreasonable costs in the hope of gaining greater value upon disposition. Such unreasonable costs might include unnecessary repairs that add no value or holding on to the asset for an extended period in the hope of a rising market, to the detriment of subsequent creditors.

In contrast to the cost and expense of disposition, the source of the pledgees’ claims for principal, interest and other amounts is the pledge agreement between the parties. These claims are conventional in nature, and do not arise by statute or operation of law. After the costs and expenses are satisfied, these claims should be satisfied in order of the priority stipulated by the legislation.

We have two observations to make concerning the current wording of Article 468.4(3) in respect of consensual claims arising directly from the pledge agreement.

a) payment of principal and interest are obligations of the loan agreement, to which the pledgor has given their consent. Assuming a provision of the type mentioned under “item A” above - that the security agreement is the source of the rights and obligations of the parties to the agreement - then it is redundant to state that the pledge extends to the interest. Every pledge agreement contains a clause of this nature.

b) prepayment penalty clauses are optional. Although common in fixed term loans and closed mortgages, they are not usually included in revolving lines of credit, or open mortgages. Their main purpose is to prevent a debtor from breaking the loan agreement and replacing it with an agreement with another lender, at a lower interest rate. The method by which a prepayment penalty is calculated varies from lender to lender, but often
it is the higher of: i) an amount equal to 3 months’ interest on what is owed; or ii) the interest rate differential.

Because they are optional, the presence or absence of a prepayment penalty clause very much depends on the agreement between the parties. The proposed wording in 468.4(3) suggests the inverse: penalties will be assessed “unless otherwise agreed by the parties”. This implies a negative option – the debtor must opt out of penalties, rather than opt in.

Please consider omitting the reference to penalties, given that these will be included in the pledge agreement at the option of the parties, and will vary with the nature of the loan type.

In addition, consider implementing or modifying consumer protection regulations to the effect that, where the parties agree to a clause of this nature, then the formula for calculating the penalty should be clearly stated, and the debtor should consent to the clause.

E) Substitution of claims by the same pledgee.

Proposed Article 468(8) provides that: “With the consent of the pledgee and of the pledgor, a different claim may be placed in lieu of the claim for which the pledge is constituted. Replacing the secured claim should not affect the rights of the creditors with a lower priority rank. The form and registration requirements will be respected in the appropriate way”.

Based on discussions with drafters of the proposed amendments to the Civil Code, this provision refers to novation. As such, it could refer to one of three different acts:

a) replacing or adding an obligation to perform with a different obligation;

b) adding a new category of collateral; or

c) replacing a party to an agreement with a different party.

The third act – replacing a party to an agreement with a different party – is presumably dealt with elsewhere in the Draft. Our commentary relates therefore to items a) and b) above.¹

a) Replacement of an obligation: Transactions in which an obligation is replaced by a different obligation are common in inventory financing, especially where there is a floor plan agreement. The loan structure in these instances often involves three parties: the supplier of goods, the dealer and the bank. The dealer purchases inventory from the supplier through the bank’s guarantee of payments to the supplier.

Legal documents would include the bank-dealer master agreement, the manufacturer-dealer master agreement, and the bank-manufacturer master agreement. The master agreements set forth the basic conditions of the relationship between the parties to the agreement, and the bank-dealer agreement, in particular, would normally grant the bank a continuing pledge in the dealer’s inventory, receipts and accounts receivable. The bank’s master agreement might contain a pledge

¹ We have a separate concern arising from this Article, referred to below under the heading on consumer protection.
clause, or the pledge might be created through a separate pledge agreement. Either way, a notice of the pledge would be registered.

Under the floor plan, the bank often enters into a drafting agreement with the supplier, whereby the bank agrees to pay documentary sight drafts covering shipments of inventory to the dealer. In this financing arrangement, a different obligation is placed in lieu of the obligation for which the pledge is constituted, each time inventory is delivered.

The registered notice in this arrangement, therefore, relates to more than one pledge agreement, and we have no concern with a blanket registration if that is the situation contemplated by proposed article 468(8).

b) Adding a new category of collateral: A greater concern arises where a new category of collateral is added through an amendment to an initial registration. For example, assume a creditor has a claim over “all inventory”, and that fact is noted on the initial registration. Subsequently, the pledgor agrees to grant the pledgee an interest over “all equipment”, in addition to the claim over all inventory, and consequently an amendment is made on the registry system. Under proposed Article 468(8), presumably the addition would not prejudice a creditor who has taken an interest in the pledgor’s equipment. By implication, the category added by the first pledgee would only rank in priority from the date of the amendment, and therefore would not affect the second pledgee’s first priority in respect of the equipment.

If this is what is meant by Article 468(8), then we have no concern in this regard. If something else is meant, then it would be helpful to have specific examples before offering comments on this provision.

c) Consumer protection: One issue that is of concern in this provision on novation is in respect of consumer transactions. By consumer transactions, we refer to transactions in which assets are used or acquired for use by a debtor primarily for personal, family or household purposes.

International best practice contains two provisions that protect consumer transactions from overreaching creditors. The first would be an exception to the rule in Article 468(8) of the Draft: best practice usually provides that blanket registrations are not permitted for consumer transactions.

The second consumer protection item for consideration is a corollary to the first. International best practice provides that a valid pledge of consumer goods is limited to specific assets sold or leased to a consumer. A pledge of consumer goods cannot be created in a generic category of assets. It should not be possible, for example, to create a pledge in “all of a consumer’s furniture”, or “all of a consumer’s computer hardware”. Generic categories are restricted to pledges of business assets.

Accordingly:

Consider inserting an exception to blanket registrations in Article 468(8), in respect of pledges involving consumer assets.
For these reasons, we would also recommend prohibiting the creation of a pledge in a generic category of consumer assets.

**F) The ban on third party access to registered information**

Proposed Article 481(3) provides that a pledgor can request a ban on third party access to information on the Registry System. This proposal reinstates Article 46 of the 2001 *Law on Pledge*, which was repealed by the 2014 amendments in accordance with a recommendation in the ROSC Report.

We understand from discussion with Ministry officials that a ban would apply to all information except a debtor’s name. The debtor’s name, therefore, would appear in the search results, but nothing else. Pursuant to Article 481(3), a searcher in this case would assume that all the debtor’s assets are pledged.

This reintroduction is a cause for concern, and it appears to contradict other provisions. For example, Article 39 of the Act lists the contents of an initial notice, and Articles 13 to 20 of the Regulations elaborate on this list. The items mentioned in these three Articles are mandatory, but this Article creates an exception. The mandatory information would not be discoverable on the system.

Article 481(3), therefore, goes against international standards and we would encourage the authors of the Draft to reconsider this position. As stated in comments A) and B) of this Note, the registration system should contain very basic information that is always accessible to third parties. Under this approach, a searcher is directed to the creditor of record in the registry, should the searcher wish to ascertain further information.

This Article defeats that purpose, and essentially would deter other creditors from dealing with a debtor who had requested a ban on information. Consequently, it is anti-competitive in that it creates a situational monopoly for the first pledgee.

It also encourages secret encumbrances. A debtor and creditor, in collusion, could enter agreements involving a pledge, purchase or lease of luxury assets, without discovery. This article could make it difficult for the Central Bank and other Government departments and agencies to ascertain the identity of secured creditors and could encourage informal moneylending arrangements and money-laundering.

Given that a secured creditor has the ability under the Draft to create a discoverable interest in all the assets of an enterprise, this ban seems unnecessary.

**G) A commercially reasonable price for an asset upon enforcement**

Article 75 of the *Law on Pledge* provides the conditions for sale of assets by a pledgee:
1. “Once the pledged asset is taken into the pledgee’s possession, the pledgee is authorized to proceed to sale of the pledged asset by direct negotiations, tender, or public auction provided it entered a notice in the registry in the manner envisaged by Article 67(2).

2. The pledgee shall sell the pledged assets without undue delay, at the reasonable commercial price and taking into account the pledgor’s interests, being free to decide on the terms of sale, unless otherwise agreed in pursuance to the provisions of paragraph (8)....” [emphasis is added]

Our concern centers on the phrase in Article 75(2): “at the commercial reasonable price”. Notwithstanding the fact that this phrase is similar to the language used in the Model Law, the concept of a “commercially reasonable price” is based on a misunderstanding of the original intention of the drafters of these models, and in practice this language creates a number of problems in Moldova.

Currently, pledgees in Moldova obtain a professional valuation of the assets, then set a reserve price and offer the assets for sale. Where the reserve is not met, the process is repeated, with a lower reserve. This process is implicitly recognized in the ROSC – hence that Report’s recommendation regarding the training of professional valuators.

We recommend that this practice be discontinued. It is based on a misunderstanding of the purpose and outcome of a private sale.

The procedure for disposition should be “commercially reasonable”. That phrase should not be directly connected with the price. The price is whatever is offered under conditions created by following a commercially reasonable process. The disposal of assets in this context is a liquidation sale. Creditors should not expect fair market value under these circumstances.

Accordingly, we recommend that the wording of Article 75(2) of the Law on Pledge – and the comparable provision in the Draft - be amended to require that the procedure for disposition of assets upon default should be commercially reasonable, not the price. In an efficient out-of-court disposition, the price is determined by buyers and sellers on the day of the sale. It is not predetermined by valuators.

What is a commercially reasonable process? Provided the disposition has been advertised appropriately and provided all parties with an interest in the asset – that is, creditors of record and the debtor – have been notified of the time and place of disposition, then the conditions for a commercially reasonable market disposition are set. Thereafter, the price is the result obtained through bargaining between buyers and sellers, under proper market conditions, within the constraints of the prevailing circumstances.

H) Ability of a pledgee to lease assets, upon enforcement

Proposed Article 494(2), paragraphs c) and d), provide that upon enforcement, a pledgee is entitled to exercise the following rights with respect to the pledged assets:
“(…)

c) obtain possession and to lease the pledged asset. In this case, the legal provisions regarding the sale of pledged tangible assets apply accordingly to the determination of the reasonable commercial rent;

d) if the pledged assets are the right of the intellectual property object, under the law, to have an exclusive right, to sell or to grant licenses for consideration to third parties. In the case of granting the licenses, the legal provisions on the sale of pledged tangible assets are duly applied when determining the reasonable commercial remuneration for the license;

(…)”

Provisions of this nature are not uncommon, and similar rights are included in Article 78(1) of UNCITRAL’s Model Law (2016). The concern raised by these provisions is with respect to the phrases “determination of the reasonable commercial rent”, and “the reasonable commercial remuneration for the license”.

Paragraph (c) refers to the application of “the legal provisions regarding the sale of pledged tangible assets...” as the relevant standard, and we have discussed the issue encountered in applying that standard above. If that standard is modified in accordance with our recommendation, then a new standard will be required for disposition by lease or licence.

We recommend that the drafters consider including factors that might lead to determination of a “reasonable commercial rent” and a “reasonable commercial remuneration for the license”. For example, comparable market rates could be one factor. Application of a market multiple might be another. In the absence of such factors, this provision could lead to extensive litigation.

In the alternative, consider a requirement that a creditor who proposes to lease or license the asset, rather than dispose of it by sale, should be required to notify all creditors of record and the debtor of the proposal. They should have a right to object, in which case the asset should be sold rather than leased or licensed. Provision of this nature would be similar to the provisions dealing with foreclosure by a seizing creditor.