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## Securing Russia's Future: A Plea for Reform in Russian Secured Transactions Law

Jason J. Kilborn

### INTRODUCTION

After many turbulent years of uneasy transition to a market economy, Russia is finally "open for business."<sup>1</sup> Nonetheless, the transitional period remains far from over, and Russian enterprises are still starved for capital that they desperately need for retooling to convert from military to consumer production, for acquiring new equipment to replace old and worn machinery, and for undertaking new and lucrative projects. While Russian financial institutions may provide significant funding, their reserves are limited; they could not hope to finance independently the multitude of existing and potential enterprises within the expansive Russian territory. Therefore, much of the financing for the continuing development of Russian business has and will come from Western sources.<sup>2</sup>

The Russian legislature recently has taken a great stride toward further enticing Western investment by adopting a new and greatly enhanced Civil Code. There, nested within a fairly detailed section on the law of obligations,<sup>3</sup> lies a subsection on various methods of securing the performance of obligations, including an expanded and sophisticated section on "pledge."<sup>4</sup>

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1. See Edward H. Lieberman et al., *New Russian Civil Code Bodes Well for Business*, NATL. L.J., Nov. 14, 1994, at C10, C11.

2. The Russian Federation has exhibited its serious desire to attract foreign investment in many ways, including, since December 17, 1995, retaining Merrill Lynch at significant expense to act as an intermediary to attract investment from foreign markets. See Rustam Narzikulov, *Merrill Lynch Demands a Denial of Sovereignty From Russia*, SEGODNIA, May 23, 1995, at 1, available in LEXIS, Busfin Library, SBE File; see also Jeff Berliner, *Russia Lures Foreign Oil Investment*, UPI, Nov. 15, 1994, available in LEXIS, News Library, UPI File.

3. The Russian Civil Code, like its European siblings, is divided into two broad "Parts": the "General Part" and the "Special Part." The Special Part in turn is divided into several sections, including the law of things (property) and the law of obligations, both consensual (contracts) and those arising out of harm occasioned on others (tort). This Note deals with part of the section governing contractual obligations and the means for securing their performance.

4. GRAZHDANSKII KODEKS ROSSIISKOI FEDERATSII [GK RF] arts. 334-358. The Russian word *zalog* in the heading of this section of the Code has been translated almost uniformly as *pledge* in scholarly commentary in English; therefore, that conven-

For any pledge system to function effectively, enticing lenders to part with their capital temporarily, the system must allow secured creditors<sup>5</sup> to feel reasonably assured that they will be able ultimately to regain their investments. Although secured creditors wish to avoid foreclosure and satisfaction from the collateral as much as debtors do,<sup>6</sup> they must have confidence that the system will provide them an acceptable means of realizing a return if eventually they are forced to foreclose on the collateral to avoid a loss.

While the new provisions on pledge have the potential to assure lenders of the security of their investments, and thus to stimulate greater flow of capital into Russian enterprises, several shortcomings might inhibit the effective achievement of the goals underlying these provisions. This Note focuses on one crucial birth defect of the fledgling Civil Code: it limits the mechanisms available to secured creditors for realizing on collateral following foreclosure by requiring that the collateral be

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tion will apply here as well. *See, e.g.*, William G. Frenkel, *New Russian Secured Transactions Regime: Analysis of the Law on Pledge*, SEEL, Mar. 1993, at 1, 1. [Unless otherwise indicated, all translations in this Note of Russian and French materials are those of the author.] One might more accurately translate the word *zalog* as *security interest*, *see* U.C.C. § 1-201(37) (1990), as it clearly encompasses much more than the narrow historical connotation of the word *pledge*, which involves an obligatory transfer of collateral to the secured creditor (a transaction described more accurately by the Russian word *zaklad*). *See infra* note 11. The reader should realize that *pledge* here is to be understood in the broader sense of "general security interest," a connotation that the term apparently has taken on in many civil law countries. *See, e.g.*, GEORGES R. DELAUME, *LEGAL ASPECTS OF INTERNATIONAL LENDING AND ECONOMIC DEVELOPMENT FINANCING* 239 (1967).

Security interests appear in a variety of contexts, but most prominently in loan transactions involving an obligation to return borrowed funds. When a consumer purchases a car with money borrowed from a bank or an automobile financier or when a factory acquires a loan from a financial institution to expand its operations, the lender desires more assurance than simply the good word of the borrower that the money will be returned. Therefore, it takes a security interest in an item of a value equal to or greater than the amount of the debt, for instance, in the examples listed above, the car or the equipment or inventory of the factory. If the borrower fails to make interest payments or to repay the loan according to its terms (in other words, if the borrower "defaults"), the security interest provides a basis for the lender to go and take the item acting as security (to repossess or "foreclose on the collateral") and dispose of it to satisfy the repayment obligation. *See, e.g.*, GK RF art. 334. From the foregoing, it should be clear that if the creditor cannot effectively enforce the security interest and dispose of the collateral, the entire effort to secure the debt has been for naught. *See infra* note 25.

5. A variety of terms exist for designating the parties in a secured transaction, such as obligor-obligee, pledgor-pledgee, creditor-debtor, and so forth. For purposes of uniformity and consistency, and in conformity with the convention in article 307 of the Russian Civil Code, this Note refers to the party to whom the secured obligation is owed as the "creditor" or the "secured creditor," and the party who owes the obligation as the "debtor."

6. *See infra* section II.B.1.

sold at public auction.<sup>7</sup> This limitation might seriously undermine creditor comfort with the personal property security system in Russia. Lack of creditor confidence in the ability to cover the potential losses of debtor default with the collateral securing loans likely will produce one of two unpleasant results: either a dearth of available loan funds will arise as creditors refuse to risk their capital, or lenders will begrudgingly provide loans only at exorbitant rates of interest, which will stifle all but the boldest of potential debtors.<sup>8</sup> In either case the progress of Russian enterprise will be greatly slowed or halted.

This Note argues that the current Russian law governing the realization of repossessed collateral is potentially harmful to both secured creditors and debtors alike, and it therefore proposes amendments that would benefit both parties.<sup>9</sup> Part I briefly examines the antecedent of the present Russian pledge law and describes the restrictions imposed by the current law. Part II looks to the pledge regimes of several European legal systems to explain and challenge the Russian approach. This Part also criticizes the Russian restriction based on the development of North American secured transactions law. Finally, Part III proposes several possible alternatives for broadening the options available to creditors for satisfying the obligations owed to them following foreclosure.

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7. See GK RF art. 350(1).

8. See, e.g., 2 I. ALAUZET, COMMENTAIRE DU CODE DE COMMERCE ET DE LA LÉGISLATION COMMERCIALE § 792, at 199 (2d ed. 1868) (quoting a French government official as he presented the proposed article 93 of the Commercial Code on commercial pledge to the French Legislative Body):

Commerce and industry need inexpensive capital; lending secured by pledge should be one of the most economical means of procuring [capital] since it confers a privilege of a certain value to the lender. Otherwise, the capitalist hesitates or demands to be paid more dearly because, in the state of legislation, he is not assured of recovering his funds at the time indicated in the contract; his reimbursement might be postponed by the spirit of chicanery and the delays of a trial.

*Id.* For a more modern expression of similar sentiments delivered by three commentators, see INTERNATIONAL CONFERENCE ON SECURED COMMERCIAL LENDING IN THE COMMONWEALTH OF INDEPENDENT STATES 22 (Jonathan Bates et al. eds., 1994) [hereinafter CIS CONFERENCE] (Alan Farnsworth: “[P]ersonal property security is regarded as vital to the successful operation of a market economy. In such an economy a system of personal property security law is therefore just as essential as a system of contract law.” *Id.* at 27-28); (Lane Blumenfeld: “Without security, financial institutions will not lend, and without lending, business cannot flourish.” *Id.* at 47); (Ronald Dwight: “The lack of an effective collateral law in Poland is one of the principal blocks to the development of modern finance in Poland and a block to the development of the entire banking system.” *Id.* at 37).

9. It is hoped that such suggestions will be especially timely now, as Russian legislation undergoes a constant whirlwind of reform and development. Similarly, as other developing countries, particularly the other former republics of the Soviet Union, begin to draft their own secured transactions laws, they may also benefit from the analysis in this Note.

## I. A BRIEF HISTORY AND THE CURRENT STATE OF THE LAW

This Part first touches briefly on the wholly insufficient attention given to pledge law during the Soviet period, then it examines the greatly improved, yet still slightly deficient, system of secured transactions in present-day Russia.

When it became apparent that secured lending would have to play a prominent role in the development of a rich new Russian market economy, Russian legislators likely built upon the base constructed by their predecessors.<sup>10</sup> During the Soviet period of a command economy, elaborate provisions for securing the repayment of debts were unnecessary because both the providers and the major consumers of credit belonged to the state. State banks made generous loans on extremely favorable terms to government enterprises. If an enterprise defaulted on its loans, the government had simply transferred funds from one pocket to another, it was of little import where the money eventually happened to accumulate. This attitude was reflected in the skeletal provisions on pledge in the old Soviet Civil Code, and no separate law existed to expand on this miserly treatment.<sup>11</sup> The few "hopelessly rudimentary"<sup>12</sup>

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10. Although this section discusses only Soviet law, prerevolutionary Russian law also included provisions concerning the pledge of property as security for obligations, which were also accompanied by various limitations on the disposition of collateral. The Sobornoe Ulozhenie of 1649 provided for obligatory and unconditional transfer of ownership of the collateral to the creditor in case of default. Ulozhenie, ch. 10, art. 196 (1649), in 1 POLNOE SOBRANIE ZAKONOV ROSSIISKOI IMPERII art. 1 (1830). During the next century, lawmakers first required public auction of collateral, then they abrogated that requirement. See A.V. CHERNYKH, ZALOG NEDVIZHIMOSTI V ROSSIISKOM PRAVE 20 (1995). Despite the legal disfavor into which public auction had fallen, however, the Russian government, which had begun to act as secured creditor, continued to include in its secured transactions a condition of obligatory public auction of collateral in the event of default. See *id.*

This government stance on public auction eventually led to reform in the permitted methods of repossession and disposition of collateral. From this reform at the turn of the nineteenth century, and for more than a century until the Revolution, Russian pledge law contained a default requirement of public auction, but the default rule was subject to exception. After the debtor had defaulted on a secured obligation, the debtor or any of her other creditors had the right to demand a public auction of the collateral. See *Ustav o bankrotakh*, pt. 2, art. 54 (1800), in 26 POLNOE SOBRANIE ZAKONOV ROSSIISKOI IMPERII art. 19692 (1830); 10 SVOD ZAKONOV GRAZHDANSKIKH I MEZHVEVYKH art. 1516 (1832) [hereinafter SVOD 1832]; [10 chast' 2] SVOD ZAKONOV ROSSIISKOI IMPERII: ZAKONY O SUDOPROIZVODSTVE I VZYSKANIYAKH GRAZHDANSKIKH art. 52 (1857) [hereinafter SVOD 1857]. But if no demand were made for two months, or if the debtor appeared and explicitly abandoned the property in fulfillment of the underlying obligation, the creditor could take the collateral as her own property "irrevocably." *Ustav o bankrotakh*, pt. 2, art. 53 (1800); SVOD 1832 art. 1515; SVOD 1857 art. 51.

11. See GRAZHDANSKII KODEKS RSFSR [GK RSFSR] arts. 192-202 (1964). These few articles afforded overly broad and yet extremely terse treatment to the pledge

provisions on pledge in the Soviet Civil Code grossly failed to provide the necessary legal framework for a practicable system of secured transactions in a Russia that at the beginning of the 1990s entered into a period of intense political, social, and commercial transformation.

The fall of the Soviet Union in December of 1991 violently diverted the attention of Russian lawmakers from political dogma to the pragmatic concerns of free-market economics. Russian legislators quickly remedied many of the inadequacies of the secured transactions provisions of the old Soviet Civil Code by enacting two new laws governing the use of personal property security. One law, the Law on Pledge,<sup>13</sup> is devoted entirely to the subject, and the new, more business-oriented Russian Civil Code<sup>14</sup> contains a section on pledge among its provisions on contractual obligations.<sup>15</sup>

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law. Yet despite their significant shortcomings, the provisions on pledge in the old Code were not totally devoid of redeeming qualities. The Soviets preserved the prerevolutionary allowance for retention of the collateral by the debtor. This saved the Soviet system from the complications of the ubiquitous insistence in world pledge law on transfer of the collateral from debtor to secured party, a problem that has plagued Western countries for centuries. See, e.g., ASSOCIATION EUROPÉENNE D'ÉTUDES JURIDIQUES ET FISCALES, SECURITY ON MOVABLE PROPERTY AND RECEIVABLES IN EUROPE 38-39, 58-62 (Michael G. Dickson et al. eds., 1988) [hereinafter SECURITY IN EUROPE]; GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 1.1, 2.1 (1965). While article 196 of the Soviet Civil Code of 1964 established a default rule of transfer of collateral to the secured party, it left open the possibility of circumventing this encumbrance by providing in the security agreement for a nonpossessory security interest. See GK RSFSR art. 196 (1964). The drafters realized that "in the majority of situations, transfer of the collateral to the secured party is impossible . . . or inexpedient," and that the circumstances in which transfer of collateral would be "practically important" were really limited to hocking an item at a pawn shop. VSESOUZNYI ORDENA "ZNAK POCHETA" NAUCHNO-ISSLEDOVATEL'SKII INSTITUT SOVETSKOGO ZAKONODATEL'STVA, KOMMENTARIJ K GRAZHDANSKOMU KODEKSU RSFSR 242-43 (S.N. Bratus' & O.N. Sadikov eds., 3d ed. 1982).

12. See Christopher Osakwe, *Modern Russian Law of Banking and Security Transactions: A Biopsy of Post-Soviet Russian Commercial Law*, 14 WHITTIER L. REV. 301, 354 (1993); see also CHERNYKH, *supra* note 10, at 27 ("[I]n our country pledge had for a long time a rather ritualistic significance, accompanying the most primitive acts of exchange." (quoting D.A. Medvedev, *Rossiiskii Zakon o zaloge*, PRAVOVEDENIE, No. 5, 1992, at 13)).

13. See Zakon Rossiiskoi Federatsyi "o zaloge" [Law of the Russian Federation "on Pledge"] No. 2872-1 of May 29, 1992 [hereinafter Law on Pledge]. See *supra* note 4 for a discussion of the terminology used here.

14. For an excellent and authoritative discussion of the new Civil Code, see generally E.A. Sukhanov, *Russia's New Civil Code*, 1 PARKER SCH. J.E. EUR. L. 619 (1994).

15. See GK RF arts. 334-358. The section of the new Russian Civil Code on pledge both supplements and limits the Law on Pledge. See GK RF art. 3(2) ("Norms of civil law contained in other laws must comply with the present Code."); INSTITUT ZAKONODATEL'STVA I SRAVNITEL'NOGO PRAVOVEDENIA PRI PRAVITEL'STVE ROSSIISKOI FEDERATSII, KOMMENTARIJ K GRAZHDANSKOMU KODEKSU ROSSIISKOI FEDERATSII, CHASTI PЕРВОI 346 (O.N. Sadikov ed., 1995) [hereinafter KOM-

These laws have tremendous potential to revolutionize the practice of securing obligations in Russia by providing greater stability and predictability to security in a broad range of tangible and intangible property rights.<sup>16</sup> Debtors are now free to secure their obligations with inventory,<sup>17</sup> the “separable and inseparable proceeds” of the original collateral,<sup>18</sup> as well as after-acquired property and property rights.<sup>19</sup> Whole enterprises can also serve as collateral, in which case the security interest extends to the entirety of the property and property rights belonging to that enterprise.<sup>20</sup> Moreover, the new law explicitly presumes that the debtor will remain in possession of these various forms of collateral, thus recognizing the greater convenience and efficiency of such “nonpossessory” security arrangements.<sup>21</sup> The new laws have also expanded the range of securable obligations to include those arising after conclusion of the security agreement.<sup>22</sup> Finally, both the Law on Pledge and the Civil Code are replete with opportunities for the debtor and the secured creditor to avoid the ready-made suppletive rules in the laws and to mold their agreement in a way that suits their particular preferences.<sup>23</sup> Such expanded and clarified treatment of the interests involved in secured transactions seems to pave the way toward the implementation of modern finance techniques in Russia.<sup>24</sup>

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MENTARI GK RF] (“The norms of [the Law on Pledge] retain their force and will be applied to the extent that they do not contradict the Civil Code.”).

16. See GK RF art. 336(1); Law on Pledge arts. 4(2), 54(1). The intangible property rights subject to pledge presumably include such things as accounts receivable, business goodwill, and intellectual property rights.

17. See GK RF art. 357; Law on Pledge arts. 46-48.

18. See GK RF art. 340(1); Law on Pledge art. 6(2).

19. See GK RF art. 340(6); Law on Pledge art. 6(3).

20. See GK RF art. 340(2); Law on Pledge art. 44(1).

21. See GK RF art. 338(1) (“The collateral shall remain with the debtor unless otherwise provided for by agreement.”). Compare this provision with the language of its predecessor: “The collateral . . . shall be transferred to the secured party unless otherwise provided by law or agreement.” GK RSFSR art. 196 (1964). *But see supra* note 11 and accompanying text. Although the practical effect of these provisions is the same, the legal presumption, and seemingly the preference, has shifted to nonpossessory interests.

22. See Law on Pledge art. 4(3).

23. See, e.g., GK RF arts. 338, 340-347, 349, 357; Law on Pledge arts. 5-6, 9, 20, 23, 25, 36-38, 44, 46, 49-51, 53-54, 56-58 (all making reference to the security agreement as a possible central or controlling factor in the determination of the rights and responsibilities of the parties).

24. See Lieberman et al., *supra* note 1, at C10; see also Osakwe, *supra* note 12, at 355 (“Without doubt, [the Law on Pledge] launches a new era in Russian law of mortgages. It catapults Russian law of security transactions into the family of Western law and will certainly persuade Western investors and lenders that it is safe to lend money in Russia.”). While the advances made possible by the new law are indeed significant, Professor Osakwe’s enthusiastic optimism about their immediate effect on the attitude

Yet the ultimate achievement of a warm financial climate may remain farther away than anxious lenders might think. Stifling restrictions imposed at the final stage of the secured transactions continuum have the potential to undermine severely the effectiveness of the many laudable advances described above. The entire complex process of negotiating, creating, and registering a security agreement is conducted on the premise that if the debtor defaults on her obligation, during the crucial last throes of the transaction the secured creditor may resort to the collateral to mitigate, and ideally eliminate, the loss.<sup>25</sup> At this pivotal point, however, the Russian Civil Code confines the parties to realizing on the collateral only through sale at public auction.<sup>26</sup>

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of Western investors in Russia may be a bit hasty. This Note points out one problem created by the new Civil Code, and there are other reasons for Western investors to remain cautious about diving headfirst into the Russian investment arena. *See, e.g.*, Lieberman et al., *supra* note 1, at C10 (“In . . . secured transactions, existing legislation is clearly inadequate. For example, although Russia requires registration of security interests, the government has been slow to create registries. Existing legislation does not adequately address priorities among creditors or the rights of creditors that simply cannot register their liens.”).

25. One commentator has excellently described the central importance of reliable default procedures:

No matter how beautifully synthesized the scholar may consider the Code's rules on priorities, after-acquired property, dominion over the collateral, or notice filing, the Code fails as a practical matter unless it effectively promotes an efficient, fair, and prompt means for the payment of the debt by resort to the collateral.

William E. Hogan, *The Secured Party and Default Proceedings Under the UCC*, 47 MINN. L. REV. 205, 206-07 (1962) (footnotes omitted); *see also* Charles Hampton White, *Tennessee Law and the Secured Transactions Article of the Uniform Commercial Code*, 17 VAND. L. REV. 835, 867 (1964) (“All of the intricate and theoretical niceties of article 9 depend upon and are, in fact, designed to deal with one catastrophe: the default of the debtor . . .”).

26. *See* GK RF art. 350(1). In contrast, the Law on Pledge allowed the parties to choose in the security agreement to deviate from the public auction requirement. Law on Pledge art. 28(2) (providing that realization shall take place as directed by civil procedural law “unless otherwise provided for by this Law or by the agreement”). However, the Law on Pledge antedates the Civil Code by two years, and the foreclosure provisions of article 28 of the Law on Pledge have been substantially modified by the new Civil Code, which controls in case of conflict. *See* GK RF art. 3(2); *see also* *Postanovlenie Plenuma Verkhovnogo Suda Rossiiskoi Federatsii i Plenuma Vyshego Arbitrazhnogo Suda Rossiiskoi Federatsii O nekotorykh voprosakh, svyazannykh s primeneniem chasti pervoi Grazhdanskogo kodeksa Rossiiskoi Federatsii* [Decree of the Plenum of the Supreme Court of the Russian Federation and of the Supreme Arbitration Court of the Russian Federation On Several Questions Connected with the Application of Part One of the Civil Code of the Russian Federation], ROSS. GAZETA, Aug. 13, 1996, at 5, 6 [hereinafter *Postanovlenie*] (“Current law does not provide for the possibility of transferring ownership of pledged property to the secured creditor. Any agreement providing for such transfer is void . . .”); *supra* note 15. Compare the Law on Pledge art. 28(1) (providing for foreclosure on movable, i.e., personal, property only through judicial decision or, in special circumstances, on the basis of an execution order issued by a notary) with the newly liberalized foreclosure provisions of the Civil Code,



The Code directs that the sale be conducted in accordance with procedural legislation, which leads the ill-fated secured creditor to the archaic Russian Civil Procedural Code.<sup>27</sup> The Procedural Code directs that a court officer shall conduct the auction and that the collateral be turned over to her for sale between five days and one month after foreclosure.<sup>28</sup> The court officer is responsible for publicizing the auction and for notifying the secured creditor — who can bid on the collateral — of the time and place of the auction.<sup>29</sup>

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discussed immediately below. Article 350 of the Civil Code appears explicitly to reverse the more liberal position on realization in the Law on Pledge. Given that the drafters of article 350 have excluded from the new Code provision any deference to the wishes of the parties, they apparently have limited the alternatives for realization of the collateral to one option: public sale.

This conclusion is supported by a comparison of the language of the foreclosure provisions in the Code with the provisions on the subsequent realization of foreclosed collateral. Article 349 of the Code provides for foreclosure on both immovable (real) and movable (personal) property “according to the decision of a court.” GK RF art. 349(1)-(2). However, article 349 expressly gives the parties the freedom to agree on a different foreclosure procedure, avoiding recourse to the court. *See* GK RF art. 349(1)-(2). Moreover, for true pledges, when the creditor holds the collateral, the parties can even define their own foreclosure procedure in advance in the security agreement. *See* GK RF art. 349(2).

The very next article, on the other hand, then orders the parties to sell this “foreclosed” collateral at public auction, and it conspicuously lacks any exception for contrary agreement, either before or after conclusion of the security agreement. *See* GK RF art. 350. Where Russian legislators have intended to provide for deference to party agreement, they have apparently done so in numerous places. *See supra* note 23. It would seem to follow that where they have not done so, Russian lawmakers have intended to prohibit any deviation from the prescriptions of the Code, and given the historical formalism of the Russian judiciary, Russian judges will likely interpret the directions in article 350 literally and exclusively. *See Postanovlenie, supra*.

27. *See* GRAZHDANSKII PROTSESSUAL'NYI KODEKS RSFSR [GPK RSFSR]. Although the Procedural Code addresses only the sale of residential structures at public auction, *see* GPK RSFSR arts. 399-405, the same provisions presumably will apply to the sale of repossessed movable collateral by similar means. *See* KOMMENTARIJ GK RF, *supra* note 15, at 359.

The Civil Procedural Code of the Russian Republic of 1964, with numerous amendments, remains the source of Russia's procedural law today. Recognizing that the old Procedural Code “almost completely fails to respond to the changed economic, political, and social conditions of Russian society . . . particularly . . . after the enactment of . . . part 1 of the Civil Code of the RF,” the Ministry of Justice of the Russian Federation has announced the completion of a new draft Civil Procedural Code. *Press-sluzhba MiuRF Podgotovlen proekt GPK RF*, ROSS. IUST., Aug. 1995, at 1, 1.

28. *See* GPK RSFSR arts. 398-399.

29. *See* GPK RSFSR art. 400. Those wishing to participate in the auction must deposit with the court officer a document certifying that they are not legally prohibited from acquiring ownership of the collateral, along with a sum equal to ten percent of the initial bidding price of the collateral. *See* GPK RSFSR art. 402. The initial bidding price is determined according to the method of foreclosure, *see supra* note 26: If foreclosure was accomplished through judicial process, then a judge will decide the initial price; otherwise, the parties must agree upon an initial price. *See* GK RF art. 350(3).

If certain procedural irregularities occur during or after the sale, the auction is declared void,<sup>30</sup> and the secured creditor receives her first chance to retain the collateral in partial satisfaction of the obligation. Unfortunately for the debtor, the secured creditor takes the collateral not in the sense of “strict foreclosure,”<sup>31</sup> but rather by crediting the initial bidding price to the remaining unpaid amount of the secured obligation and pursuing a deficiency remedy for the remainder.<sup>32</sup> Moreover, the secured creditor can bide her time, refuse the collateral, and await a repeat auction.<sup>33</sup> If the auction is declared void a second time, the secured creditor can appropriate the twice-spurned collateral and credit the debtor for an amount “no more than ten percent less than the initial sale price of the collateral at repeat auction.”<sup>34</sup> If the secured creditor fails to take the collateral and credit the debtor, the security agreement terminates.<sup>35</sup> If, on the other hand, the collateral produces a return at auction in excess of the obligation, the secured creditor is obligated to return the excess to the debtor,<sup>36</sup> although any surplus return is, as one prominent commentator has observed, but a “glittering mirage.”<sup>37</sup> The “grim reality” is an inadequate return on the collateral and a deficiency demand by the secured creditor.<sup>38</sup>

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One can imagine the tribulation that the parties might undergo in arriving at a mutually acceptable price, and the law seems to ignore this problem entirely. For criticism of the problem of establishing a fair price at auction, see CHERNYKH, *supra* note 10, at 80.

30. In order to take her prize, the winning bidder must within five days remit the entire amount of the winning bid, minus a credit for the initial 10% deposit, and if she fails to present the funds within the time period, her 10% deposit forfeits to the state and the auction is declared void. See GPK RSFSR arts. 402, 403(3). The auction proceedings suffer a similar fate if fewer than two bidders appear at the auction or if none of the bidders proposes a bid in excess of the initial price. See GPK RSFSR art. 403(1)-(2).

31. Strict foreclosure involves acceptance by the secured creditor of the collateral in full satisfaction of the obligation. See 4 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 34-9 (4th ed. 1995). The procedure provided by the Russian law is not such an even-up transaction.

32. See GK RF art. 350(4)-(5).

33. The court officer may announce a second auction no sooner than ten days after the initial failed proceedings, and the repeat auction begins at the agreed initial bidding price or “at the first price offered.” See GPK RSFSR art. 404.

34. GK RF art. 350(4).

35. See GK RF art. 350(4).

36. See GK RF art. 350(6).

37. See GILMORE, *supra* note 11, § 43.2, at 1188.

38. See *id.*

## II. POSSIBLE RATIONALES FOR AND CRITICAL ANALYSIS OF THE LIMITATION TO PUBLIC SALE

Due to the lack of readily accessible legislative history in Russia,<sup>39</sup> one can only speculate about the motivations of the Russian legislature in crafting the secured transactions law as it did. However, Russia joins a number of other European countries in statutorily requiring realization of collateral through public auction, and the reasoning of those other countries' legislatures for imposing the restriction provides the best source of insight into the rationale for the Russian legislators' similar decision. This Part reveals that the European limitations have been eroded in many ways not present in the Russian context, and it argues that the reasoning behind the limitation is not as well founded as its proponents originally thought. Section II.A discusses certain European realization regimes and argues that, despite the apparent adoption of the public auction limitation by several commercially sophisticated Western European states, each of these systems actually allows greater flexibility than might immediately appear. Section II.B scrutinizes the major policy consideration for restraining the creditor and argues that little or no protection is necessary to counter creditor laxity during realization because the creditor has a vested interest in maximizing resale price. Moreover, this section demonstrates that the current language of the Russian law expands, rather than limits, opportunities for abuse by the creditor. Finally, section II.C challenges the restriction based on the development of secured transactions law in North America.

### A. *Western European History and Practice*

Since the countries of Western Europe have engaged in free-market commerce for a significant amount of time and have accumulated a rich history of practice over many years, Russian lawmakers understandably looked to several of their Western neighbors for guidance in drafting their new Civil Code.<sup>40</sup> Particularly given the Netherlands' recent com-

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39. See E-mail from Peter Maggs, Professor, Univ. of Ill. School of Law, to author (Mar. 20, 1996); E-mail from Brenda Horrigan, atty., Salans, Hertzfeld & Heilbraun, Moscow, to author (Apr. 7, 1996); E-mail from Ilya Nikiforov, Administrator, FPLEGAL Digest, to author (Mar. 23, 1996).

40. See, e.g., 2-A THOMAS H. REYNOLDS & ARTURO A. FLORES, FOREIGN LAW: CURRENT SOURCES OF CODES AND BASIC LEGISLATION IN JURISDICTIONS OF THE WORLD Russia 5-6 (1996) ("Major consulting sources for this effort were Dutch, German and other western European scholars, who worked with Russian experts in the drafting process."). American experts participated in the effort to a lesser extent. See, e.g., Jonathan H. Hines, *Russia's New Civil Code Further Improves Climate for Business*, SEEL, Jan. 1995, at 1, 1.

pletion of an intensive redrafting of the Dutch Civil Code,<sup>41</sup> advice from the Dutch was undoubtedly of great value to the Russian drafting process, and German scholars also provided significant consultation in the drafting effort. Although direct French participation was limited, the venerable Code Napoléon and the history of its adoption provide insight into the possible motivations of the Russian drafters, particularly regarding their decision to impose the public auction restriction.

This section examines the provisions on pledge in the civil codes of the Netherlands, Germany, and France, focusing on the rigidity or flexibility with which they regulate a creditor's actions in realizing on collateral after foreclosure. After presenting the general limitation in each code, this section points to the language of the codes and to contemporary practice to show that the limitations of the European laws are not as confining as they initially might appear in isolation. Therefore, the strictures of the Russian Civil Code, while supposedly founded on European practice, actually bind creditors' hands significantly more than their Western European counterparts. This section also alludes to possible application of these European approaches in the Russian context. Section II.A.1 examines statutory language that confines and provides exceptions to the public auction limitation. Section II.A.2 discusses the dilution of the limitation by narrow interpretation of the statutory language. Finally, section II.A.3 looks beyond the codes to commercial practice that sidesteps the pledge law entirely and relies on other, more permissive legal constructs for security.

### 1. *Other Code Provisions*

The German, Dutch, and French Civil Codes all contain some provision initially dictating that, following foreclosure, the creditor shall effectuate a resale of the collateral in order to satisfy her demands by way of public auction.<sup>42</sup> However, while the Russian Code stops here, the European codes continue and offer greater flexibility by retreating from the initial, bright-line limitation.

One important exception in the European codes is an allowance for sale by a broker when the collateral consists of property normally sold on a recognized market. The German Civil Code, for example, provides that if the collateral has an "exchange or a market price," the creditor

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41. The new Dutch Civil Code came into effect on January 1, 1992, replacing the Civil Code of 1838. *See* STEVEN R. SCHUIT ET AL., *DUTCH BUSINESS LAW* § 7.01[2] (3d ed. Supp. 1993). The revision included a wholesale redrafting of the section on the law of property, including the law of pledge. *See id.*

42. *See* BÜRGERLICHES GESETZBUCH [BGB] arts. 1228, 1235(1) (F.R.G.); BURGERLIJK WETBOEK [BW] art. 3:250 (Neth.); CODE CIVIL [C. CIV.] art. 2078 (Fr.).

may effect the sale through a broker.<sup>43</sup> The Dutch inserted a similar exception into their law in the case of publicly traded commodities and securities.<sup>44</sup> For "commercial" pledges, the French Commercial Code also permits the sale of collateral by an agent more familiar with the specific goods involved.<sup>45</sup> This logical and constructive exception is curiously absent from the Russian Code. Professional brokers who have experience selling such items are clearly better positioned to garner a suitable price for such collateral than the public officer who would otherwise be responsible for conducting the sale.<sup>46</sup>

Admittedly, of the Russian entities that might offer expertise in selling specific commodities, such as the new securities exchange, many currently lack the experience and reliability of their Western counterparts. However, for producing the highest possible returns on sales, they nonetheless represent a forum clearly superior to a simple public auction conducted by a court officer. The parties should be allowed, indeed encouraged, to take advantage of the appropriate ready-made markets when they exist. Professional brokers can offer the knowledge and the resources to ensure the most acceptable return on the types of collateral with which they are used to dealing. Even the most experienced court officer could not compete with those professionals whose business consists entirely of maximizing the return on such items.

A more significant exception that appears in both the German and Dutch Civil Codes allows the parties to deviate freely from the confines of the public sale when they feel that a modified procedure more likely would lead to an optimal return. After default has occurred, the parties may privately agree to seek realization of the collateral in some other way, such as through private sale.<sup>47</sup> Moreover, if either party feels that a method of sale other than that prescribed by the law more equitably protects her interests, that party may demand that the disposition take place in that way.<sup>48</sup> If the parties fail to agree on an alternate method of

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43. See BGB arts. 1235(2), 1221 (Simon L. Goren trans., 1994).

44. See BW art. 3:250(1).

45. See CODE DE COMMERCE [C. COM.] art. 93; see also 2 ALAUZET, *supra* note 8, § 795, at 202; SECURITY IN EUROPE, *supra* note 11, at 40.

46. See GPK RSFSR arts. 398-399 (discussed *supra* note 28 and accompanying text); see also *infra* notes 143, 151-54 and accompanying text.

47. See BGB art. 1245; SCHUIT ET AL., *supra* note 41, § 7.02[6][a][i]. A clever means of bypassing domestic regulation by party agreement evidently exists in the Netherlands, where the parties may at any time agree on a sale of the collateral abroad, "in which case the requirement of a sale by public auction does not apply." SECURITY IN EUROPE, *supra* note 11, at 125.

48. See BGB art. 1246; BW art. 3:251; see also SCHUIT ET AL., *supra* note 41, § 7.02[6][a][i] ("The President of the District Court may, at the request of either the

sale, a court then decides which method to pursue.<sup>49</sup> The Russian Code provides no such options.

## 2. *Narrow Interpretation of the Limitation*

Although the clear wording of the European codes may seem strictly to limit the creditor to only one option for disposing of the collateral, in some cases European courts and commentators have made broad inroads into these restrictions by reading exceptions into the language of the initial rules. If Russian courts apply similar interpretations to the current Russian provisions, creditors might regain substantial freedom. These alternate remedies are, however, by no means wholly satisfactory, and the extensive experience and analysis leading to such alternatives in Western Europe has not yet had time to develop in Russia.

These inferential exceptions to the public auction requirement have wedged their way between the cracks of the statutory building blocks from the very beginning. At his first presentation to the Conseil d'Etat<sup>50</sup> of the draft of what eventually would become article 2078 of the Code Napoléon,<sup>51</sup> Théophile Berlier<sup>52</sup> noted that the restrictions on disposition of collateral could be avoided entirely simply by having the debtor transfer title to the collateral by sale to the creditor.<sup>53</sup> Despite the concerns of many commentators who feared that this might give rise to fraud, the sale could be accomplished even before the debt became due — presumably as soon as the parties had concluded the security agreement.<sup>54</sup> Moreover, since the debtor could agree to sell the collateral to

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pledgee or the pledgor, order a different form of sale, such as a private sale to a specific third party, so that higher proceeds may be realized.”).

49. See BGB art. 1246(2).

50. The Conseil d'Etat in postrevolutionary France was the de facto lawmaker of the time. See [4 Deuxième partie] PIERRE LAROUSSE, GRAND DICTIONNAIRE UNIVERSEL DU XIX<sup>e</sup> SIÈCLE 973-74 (1982).

51. Article 2078 contains the provision that requires disposition of repossessed collateral by public auction.

52. Berlier was the reporter for the legislative section of the Conseil d'Etat, of which he was, accordingly, a member. See 16 LOCRÉ, LA LÉGISLATION CIVILE, COMMERCIALE ET CRIMINELLE DE LA FRANCE 1 (1829); see also [2 Première partie] LAROUSSE, *supra* note 50, at 589.

53. See 15 P.A. FENET, RECEUIL COMPLET DES TRAVAUX PRÉPARATOIRES DU CODE CIVIL 197 (1827).

54. Certain creditors, critics suspected, could easily take advantage of the inferior bargaining position of the debtor and pressure the debtor into an unfavorable sale, thus appropriating the collateral at a price well below its real value. See, e.g., 18 M. DURANTON, COURS DE DROIT FRANÇAIS SUIVANT LE CODE CIVIL § 537 (1844).

Nevertheless, Duranton indicates that it was judged better to avoid establishing a formal prohibition of such sales when abuse was “almost impossible to foresee.” See

the creditor, she could just as easily consent to a sale by the creditor to a third party, completely unconstrained by the provisions of article 2078.<sup>55</sup> Thus, the commentators made amply clear that article 2078 sought to avoid abusive creditor tactics only in the guise of a *clause* in the security agreement granting the creditor the right *ex ante* to diverge from the formalities of the law. In contrast, a postdefault *agreement* achieving a functionally equivalent result was entirely acceptable to the *conseillers*.

Additionally, commentators reveal various means of avoiding even the bedrock aversion to the "*pacte comissoire*," which consists of a clause in the security agreement allowing the creditor to retain the collateral in the event of default. The parties could, for example, insert into their security agreement a clause authorizing the creditor to retain the collateral without recourse to the judiciary for proper valuation, as directed by article 2078, but rather according to the valuation assigned to the collateral by third parties chosen by the debtor and creditor.<sup>56</sup> Particularly daring creditors could take advantage of an arrangement bearing an even more striking resemblance to the *pacte comissoire*: the parties could agree in the security agreement that, in the event of default, the creditor would be allowed to choose any item from the property of the debtor as payment of the debt. Such a "conditional sale," even though clearly "not absolutely without danger for the debtor," was viewed as beyond the reach of the pledge law and therefore an acceptable circumvention of its restrictions.<sup>57</sup>

Through similar liberal interpretation of the Russian Code, Russian judges might broaden the range of options available to secured parties.<sup>58</sup>

*id.* Similarly, another commentator wondered how one could, "without exaggerating and showing oneself to be more rigorous than the law itself," annul the debtor-to-creditor sale in such a case. 2 PAUL PONT, *EXPLICATION THÉORIQUE ET PRATIQUE DU CODE CIVIL* § 1162 (1867). While recognizing that the Code would nullify a *clause* in the security agreement that authorized the creditor to appropriate the collateral upon default, i.e., a *pacte comissoire*, Pont argues that negotiated *sales* are substantively different:

The loss of property is not here, as in the *pacte comissoire*, subordinated to a condition: the debtor immediately perceives the consequences of the consent that he is going to give; and if the conditions of the sale are too unfavorable to him, it is presumed that he will resist the obsessions of the creditor.

*Id.*

55. See PONT, *supra* note 54, § 1163.

56. See *id.* § 1159.

57. See *id.* § 1160; see also 7 J.M. BOILEUX, *COMMENTAIRE SUR LE CODE NAPOLÉON* 134-36 (6th ed. 1860).

58. The Russian Code, however, is apparently not as amenable to exceptions as is the French Code. The language of the French provision limits only clauses in the original security agreement and allows room for later agreements to modify the parties' re-

After all, party agreement may now control the method of foreclosure;<sup>59</sup> why not simply extend that liberalism to realization? Such a judicial approach would strengthen the position of creditors significantly and possibly give them greater confidence in the pledge law. But particularly because the civil law system of Russia would not recognize any binding effect of the precedent set by such judicial interpretations, direct legislative revision of the law would be preferable to vague reliance on possible judicial activism.

### 3. *Independent Evasive Techniques*

Finally, various security devices and practices, divorced from the code framework, eventually developed in Europe to fill the void created by the overly confining code provisions on pledge.<sup>60</sup> These formalistic devices allow the parties to subject their transaction to a different set of rules that better accommodates their wishes by simply calling it by another name. Indeed, these extrastatutory devices have largely replaced the pledge as the choice for securing obligations.<sup>61</sup> Each of the major alternate forms involves some sort of manipulation of title since if the creditor holds legal title to the collateral, she is free to dispose of the collateral in any way desired. This section focuses on two independent

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sponsibilities. See C. CIV. art. 2078 ("Any clause [in the security agreement] that would authorize the creditor to appropriate the collateral or to dispose of it without regard to the above formalities shall be null." (emphasis added)). The Russian provision, in contrast, mentions neither clause nor agreement. It simply directs that the collateral be realized through public auction. See GK RF art. 350. The historical formalism of the Russian judiciary would seem to indicate that no exception will be ascribed to the clear language of the Code. See *Postanovlenie*, *supra* note 26.

59. See GK RF art. 349(2); see also *supra* note 26.

60. These independent security devices emerged mainly to overcome the problematic requirement of obligatory transfer of possession of the collateral to the creditor. See, e.g., SECURITY IN EUROPE, *supra* note 11, at 38, 58-59, 123 ("[I]n fact there is no real choice [between pledge and other forms of security interests] since in the case of pledge . . . the pledgor must give up possession . . . which in most cases is not a practical proposition . . ."). Although Russian law rectified this crucial complication long ago, see *supra* note 11, the means by which European creditors acquired nonpossessory security interests also often provided them with more liberal realization procedures as well. Therefore, this discussion is still applicable to the Russian problem of limited realization mechanisms.

61. See, e.g., CIS CONFERENCE, *supra* note 8, at 56 ("[Pledge] has lost through banking practice [using fiduciary transfer of title] almost any practical importance."); NORBERT HORN ET AL., GERMAN PRIVATE AND COMMERCIAL LAW 185 (Tony Weir trans., 1982) (indicating that the institution of taking security through pledge of movable property has lost its importance in Germany as other more flexible forms of security, such as retention of title and security title, have taken its place); SECURITY IN EUROPE, *supra* note 11, at 38 ("Generally speaking, French law has seen a certain move away from traditional forms of security interest based on a pledge.").



security devices: retention of title, which is limited to purchases on credit extended by the vendor, and fiduciary transfer of title, a more flexible and widely applicable device.

Often sellers are willing to part with their wares only if they can be assured payment, and one way that this has been accomplished is by sellers initially retaining title to the goods after sale on credit. The seller releases possession of the goods to the buyer but retains legal title until the buyer transfers the full amount of the purchase price. The parties in such common situations have created the functional equivalent of a nonpossessory pledge: the seller-creditor makes a loan of the purchase price to the buyer-debtor secured by the item purchased. Here, however, the creditor is not plagued by the cramping restrictions of the pledge law because she is, after all, the owner of the collateral and may simply regain the item from the debtor upon default for unhindered disposition.<sup>62</sup>

This method of evading the constraining pledge law still occupies a prominent position in Germany today, as sellers commonly seek protection in what they call *Eigentumsvorbehalt*, or reservation of title.<sup>63</sup> Upon eventual satisfaction of the condition precedent of full payment in the sales contract,<sup>64</sup> title to the goods transfers to the purchaser, but the seller remains fully protected as legal owner of the goods until then.<sup>65</sup> An almost identical legal framework of retention of title exists in the Netherlands,<sup>66</sup> and a similar device protects French merchants as long as an agreement (perhaps in the sales contract) providing for retention of title is executed upon or before delivery of the goods to the buyer.<sup>67</sup>

Russian sellers might be able to take advantage of an analogous device, but this is by no means certain, and explicit provisions of the Code may quell any such attempts. In the new section on property

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62. This ancient practice enjoyed widespread use as a security device in the United States under the name "conditional sale" for an extended period before merging into the general category of "security interests" in the Uniform Commercial Code. See GILMORE, *supra* note 11, §§ 3.1-3.8.

63. See, e.g., HORN ET AL., *supra* note 61, at 183. This manipulation of the law of secured transactions found its origin in a section of the German Civil Code that permits vendors to retain legal ownership of property sold until full receipt of the purchase price. See BGB art. 455.

64. "Extremely widespread" clauses enumerating such conditions appear in "almost all credit sales" in Germany. HORN ET AL., *supra* note 61, at 183.

65. See Hans Stoll, *Droit des Biens*, in 3 INTRODUCTION AU DROIT ALLEMAND (RÉPUBLIQUE FÉDÉRALE): DROIT PRIVÉ 131, 189 (Michel Fromot & Alfred Rieg eds., Pierre Chenut & Jean-Marc Hauptmann trans., 1991) ("[T]he seller can fully invoke the right of ownership, which continues to belong to him.").

66. See SCHUIT ET AL., *supra* note 41, § 7.03.

67. See, e.g., Stephan H. Haimo, *A Practical Guide to Secured Transactions in France*, 58 TUL. L. REV. 1163, 1174-75 (1984).

rights, the Russian Civil Code explicitly recognizes a broad range of discretionary rights of the owner of property to do with that property what she will.<sup>68</sup> Among these rights is the discretion “to transfer [to third parties], while remaining the owner, the rights of possession, use, and disposal of the property . . . and to encumber [the property] in other ways.”<sup>69</sup> This provision may act as a vehicle to allow sellers to transfer sold goods into the possession of buyers on credit while retaining title until the purchase price has been paid.

However, sellers ought not attempt this procedure without seriously considering the code provision on the invalidity of fictitious and sham transactions.<sup>70</sup> If any sort of dispute were to arise at the execution stage — or at any other time — a court might either invalidate the entire transaction, leaving the seller completely unprotected, or divert the parties back to the prescribed track by applying the rules on pledge — “the transaction that the parties actually had in mind.”<sup>71</sup> Nevertheless, one of the innovations of the new Code is an implication that other forms of security might arise,<sup>72</sup> so it remains to be seen how Russian courts will react to independent security devices like those that have developed in Western Europe.

While retention of title represents an excellent source of security for credit sales, its applicability is limited to sellers who initially hold legal title to the goods. Retention of title is unavailable to other lenders who bear only an indirect relationship to the collateral. In order to fill

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68. See GK RF art. 209.

69. GK RF art. 209(2).

70. See GK RF art. 170. The new article 170 appears to be simply a slightly reworded variant of its little-used predecessor in the RSFSR Civil Code, article 53. This may indicate that the revised article will change nothing, and only if the hidden transaction is illegal will the judiciary reject the alternate structure. See KOMMENTARI GK RF, *supra* note 15, at 216 (“As a rule, the transaction that the sham transaction conceals is illegal.”). On the other hand, attempting to take advantage of the buyer and create an extrastatutory security interest may be considered manipulative enough to apply this article. See *id.* (noting, as examples of hidden transactions counteracted by this article, the conclusion of transactions by a legal entity beyond the description of its purposes listed in its foundation documents, and the conclusion of transactions without a proper license to engage in such activity).

71. GK RF art. 170(2).

72. See GK RF art. 329(1) (listing the methods of securing obligations, concluding with “other methods provided for by law or agreement”). Professor Sukhanov, one of the leaders of the drafting team, has emphasized the freedom of contract aspects of the new Code, particularly in the section on possible alternate forms of security. See E. Sukhanov, *Novyi Grazhdanskii Kodeks Rossii, ZAKONNOST'*, Mar. 1995, at 2, 5; see also B. Zavidov & N. Kurtsev, *Zalog — odin iz sposobov obespecheniia obiazatel'stv*, *ROSS. IUST.*, Aug. 1995, at 14, 14.

this void, German and Dutch practice produced a mutation of the retention of title device, called fiduciary transfer of title.<sup>73</sup>

Given its flexibility and wide applicability, fiduciary transfer of title has become the most commonly used security device in Germany.<sup>74</sup> The concept of *Sicherungsübereignung* is achieved by simple agreement that title to the collateral be transferred to the creditor.<sup>75</sup> The debtor retains her crucial possession of the collateral, but the creditor acquires a temporary property right in the collateral that terminates after performance of the obligation.<sup>76</sup> Just as the parties agreed to vest title temporarily in the creditor, so they are free to agree on how the interest thus created is to be enforced, including the particular means of realizing on the collateral.<sup>77</sup> Given the option, the parties normally choose to salvage the value of the collateral through private sale.<sup>78</sup> Thus, fiduciary transfer of title from debtor to creditor allows the parties to avoid the limitations of the pledge law and design their own system of controls.

Here again, while Russian property law appears to accommodate such arrangements, the judiciary may simply step in and invalidate them as sham transactions concealing a security interest.<sup>79</sup> The coopera-

73. Because the Dutch law of fiduciary transfer of title largely resembled the German law and, more importantly, because the new Dutch Civil Code expressly invalidates the device today, *see* BW art. 3:84(3), the discussion in this section will be limited to Germany.

74. *See* SECURITY IN EUROPE, *supra* note 11, at 58. Some of the various areas in which the security title device has been applied include "commerce (contents of warehouses), in industry (machinery and means of production), and even in the domestic sphere (chattel mortgages of automobiles, television sets, etc.)." HORN ET AL., *supra* note 61, at 186.

75. *See* SECURITY IN EUROPE, *supra* note 11, at 63. Note that this device performs "exactly the same function as pledge." HORN ET AL., *supra* note 61, at 186. As in retention of title, fiduciary transfer of title evolved from articles of the German Civil Code permitting full transfer of title to goods without relinquishing possession. *See* BGB art. 930.

76. *See* SECURITY IN EUROPE, *supra* note 11, at 63. Notice that this sort of non-possessory arrangement contravenes the policy of the Civil Code provisions on pledge, especially given that the security interest is completely secret as the debtor retains ostensible ownership. Nonetheless, business practice in Germany demanded such a device, and the judiciary "made short shrift of [legal] scruples," thus accommodating practical demands as case law forged the new device from parts of the existing law. *See id.*; HORN ET AL., *supra* note 61, at 186 ("With the invention of security title . . . ownership has gained a new function, for which it is perhaps formally too powerful.").

77. *See* SECURITY IN EUROPE, *supra* note 11, at 64. One source suggests that, in the absence of contrary indications in the agreement, the creditor must dispose of the collateral in a way leading to the "most favorable result possible, taking into account the circumstances." Stoll, *supra* note 65, at 188.

78. *See* CIS CONFERENCE, *supra* note 8, at 56 (comments of Professor Stephan Breidenbach of the European University "Viadrina," Frankfurt/Oder).

79. *See supra* notes 68-71.

tion of the German bench was crucial to the success of this, in effect, fraudulent practice,<sup>80</sup> and any enterprising creditor should assure herself in advance, to the extent possible, that the members of the Russian judiciary would be as accommodating as their German colleagues to this aberrant scheme.<sup>81</sup>

B. *The Myth of Creditor Machinations and the Adverse Effects of Attempts to Control Them*

Perhaps the most compelling reason for imposing a variety of restraints on the disposition of repossessed collateral is the desire to protect the debtor from a potentially overreaching, uncaring, and generally abusive creditor. Lawmakers feel that the creditor occupies a position of advantage over the debtor from the beginning and that, in order to level the playing field, the law must make every provision for controlling possible abuse by the creditor. This section argues that such fears are largely unfounded and that the restrictions of the Russian law on creditors' options for disposing of repossessed collateral are potentially counterproductive. Section II.B.1 examines the concerns that generally compel policymakers to inhibit creditor freedom and submits that they are misplaced because the interests of debtor and creditor often coincide, especially at the stage of disposition of the collateral. Section II.B.2 demonstrates that the specific Russian provisions on public sale of the collateral exacerbate potential problems with abusive creditor tactics.

1. *Shortsighted Debtor Protection and Creditors' Vested Interest in Maximizing Resale Proceeds*

Lawmakers have been admirably concerned with the plight of secured debtors from the early days of the formation of debtor-creditor policy. In his presentation of the pledge section of the Code Napoléon to the French Legislative Body, Berlier<sup>82</sup> expressed his fear that, since "[t]he creditor makes the law for his debtor" in a pledge transaction, an otherwise "undoubtedly" positive means of securing the performance of obligations might become "odious and contrary to public policy if its

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80. See *supra* note 76. Judicial cooperation was similarly essential to the advent of security title in the Netherlands. See SECURITY IN EUROPE, *supra* note 11, at 126; SCHUTT ET AL., *supra* note 41, § 7.02[1][c].

81. A recent expression of the Supreme Court and the Supreme Arbitration Court's view of current law seems to curtail hope for potential Russian judicial activism. See *Postanovlenie*, *supra* note 26.

82. See *supra* note 52.

result were to enrich the creditor while ruining the debtor.”<sup>83</sup> Unrestricted creditor freedom might give rise to fraud on the part of “greedy creditors,” who, the argument goes, would seek to “procur[e] an excessive interest” by assigning only an insignificant value to the otherwise highly valuable collateral.<sup>84</sup>

To avoid this problem, policymakers had to decide upon an appropriate mechanism for controlling the untrustworthy creditor and standardize the greatest return from the collateral. The debtor “finds his guarantee and his safeguard in the publicity of the sale, that is to say, in the call to the bidders, whose presence and competition give [the debtor] in some way the assurance that the pledge will be taken at its just value.”<sup>85</sup> Public auction was supposed to shield the debtor from the chicanery in which the creditor normally would engage if she were given free reign over the sale procedure.<sup>86</sup>

The virtues of obligatory public auction were subject to dispute, however, from the very beginning. One member of the French Conseil d’Etat suggested omitting the second clause of article 2078 from the Code, thereby permitting the parties to derogate in the security agreement from the general restriction where it suited them.<sup>87</sup> Berlier strongly opposed this proposition. He suspected that if the protection of the debtor were left to the will of the parties, the creditor would be free to impose upon the debtor her will from a superior bargaining position. In such case, “a creditor of a sum of 1000 francs who held in pledge an asset worth 3000 francs would rush to sell it at an unfair price in order to be more promptly paid.”<sup>88</sup> In such a way, the security agreement might “degenerate into a usurious contract.”<sup>89</sup> Thus, as Berlier’s posi-

83. FENET, *supra* note 53, at 206.

84. DURANTON, *supra* note 54, § 537.

85. PONT, *supra* note 54, § 1153. Another commentator quotes the “orator of the Government” as asserting that public sale “assures the most favorable conditions for the realization of the pledge.” 2 ALAUZET, *supra* note 8, § 792.

86. See PONT, *supra* note 54, § 1158 (noting that provisions in the security agreement permitting derogation from the law are likely to “place the debtor at the mercy of the creditor”).

87. See FENET, *supra* note 53, at 197. See *supra* note 58 for the text of the second part of article 2078.

88. FENET, *supra* note 53, at 197; see also PONT, *supra* note 54, § 1156. Nicolas Ollivant of the European Bank for Reconstruction and Development paints a very different, and probably more accurate, picture of the foreclosure sale: “[W]hen there is a default on a payment, the bank moves in and takes the assets, which instead of being worth 200% of the loan, suddenly, magically, become worth maybe 50% of the loan.” CIS CONFERENCE, *supra* note 8, at 79.

89. BOILEUX, *supra* note 57, at 131. Boileux further explains that “[the] sole goal of the [intervention of the court] is to protect the debtor from a usurious convention.” *Id.* at 133. He apparently has little confidence in the moral standards of any creditor, as

tion finally emerged as the norm, both the letter and the spirit of the law seemingly aimed to protect the debtor.<sup>90</sup>

Berlier's view of the rapacious creditor is subject to challenge on several fronts. First, while in some discrete circumstances the debtor may need protection, at the outset it must be emphasized that the normal creditor is just as averse as the debtor, if not indeed more so, to foreclosure and forced liquidation of the collateral.<sup>91</sup> Creditors take security interests not to profit at the expense of debtors who are likely to default, but in order to protect themselves if the debtor proves unable to fulfill her obligations. No rational creditor actually desires to subject herself, and the collateral on which she depends to satisfy the debt, to the process of foreclosure and realization — a process invariably attended by an increase in transaction costs and a risk of inadequate return.<sup>92</sup>

Even in the rare case when the possibility of a surplus from a sale exists, the creditor has every incentive to maximize resale price immediately so as to avoid any possibility of the need to resort to the judicial process to regain the remainder of the outstanding debt.<sup>93</sup> While resale

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he notes that “[o]therwise the creditor would never miss the opportunity to employ this means to escape the prohibitive rules of article 2078.” *Id.* at 134. Boileux would “always presume” that predefault agreements providing the creditor with greater flexibility “mask usury,” and that the debtor, subjugated to the will of the creditor by life’s circumstances, signed an adhesive agreement. *See id.* He concludes solemnly that “[t]he law uncovers fraud no matter under what veil it conceals itself.” *Id.*

90. *See* PONT, *supra* note 54, § 1148.

91. *See, e.g.,* Aubrey L. Diamond, *The Reform of the Law of Security Interests*, in 42 CURRENT LEGAL PROBLEMS 1989, at 231 (Roger Rideout & Jeffrey Jowell eds., 1990).

Most creditors holding security interests will agree that the last thing they wish to do is to enforce the security interest. What they want is payment of the debt, and they do not wish to undergo the trouble and expense of enforcement, which is regarded very much as a last resort.

*Id.* at 231-32; *see also* William B. Davenport, *Default, Enforcement and Remedies Under Revised Article 9 of the Uniform Commercial Code*, 7 VAL. U. L. REV. 265, 267 (1973) (“Naturally, the consequences of default are the last things that any party to a secured transaction wants to consider, and the default itself the last thing that any party wants to happen.”). These comments are corroborated by Nicolas Ollivant, Credit Officer at the European Bank for Reconstruction and Development in London: “Banks never want to take the collateral and have to sell it. It is a difficult, time consuming, frustrating, and ultimately loss making process.” CIS CONFERENCE, *supra* note 8, at 78.

92. One commentator aptly points out that any creditor who purposely seeks out debtors likely to default and secures the debts relying on the eventual opportunity to profit upon realization of the collateral “is usually either a knave or a fool.” Hogan, *supra* note 25, at 205. For an early contrary view, *see supra* note 89.

93. *See, e.g.,* CIS CONFERENCE, *supra* note 8, at 58 (comments of Professor Breidenbach recognizing that the interests of the debtor and creditor at disposition are “at least partially identical”). For an excellent and highly detailed examination and cri-

of the collateral is costless to the creditor — given that the expenses of the sale are secured by the sale proceeds along with the amount of the secured debt<sup>94</sup> — any amount the creditor manages to regain against the odds in a deficiency proceeding comes at the dear price of great expenditures of time, money, and nerves. Schwartz sums up the situation well:

Perhaps a more concise way of putting this is that every dollar the creditor nets by resale reduces the outstanding debt by a dollar; every dollar the creditor defers to the deficiency action to collect will reduce the outstanding debt by less than a dollar because the expected value of a litigation dollar is less than one, these dollars being subject to risk and delay.<sup>95</sup>

Any creditor who hopes to wring any more than the collateral out of the defaulting debtor exposes herself to the constant risk of imminent insolvency of a person who has once already proven unable to repay her financial obligations.

Second, the fear that collateral with a value greatly exceeding the amount of the debt will be sold off by a thoughtless creditor for substantially less than its “real worth” is, in most cases, unsupported by the harsh realities of the forced resale market.<sup>96</sup> Collateral, unfortunately, does not come with a neat price tag attached that explicitly indicates its “value.” The value of an item must be determined according to what the market will produce.<sup>97</sup> One common indicator of “fair” market value is the amount that a willing buyer under no compulsion to purchase would offer for the item in an arm’s length sale by a willing seller under no compulsion to sell.<sup>98</sup> In the context of a forced disposition following default, neither the creditor nor the debtor is a particularly willing seller. This makes it difficult to achieve or even to predict

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tique of the proposition that creditors fail to maximize resale prices on a consistent basis, see Alan Schwartz, *The Enforceability of Security Interests in Consumer Goods*, 26 J.L. & ECON. 117, 124-39 (1983). In an appendix to his article, Schwartz provides a complex mathematical proof of his claim that creditors always benefit from maximizing the proceeds of collateral sales. *See id.* at 161-62.

94. *See* GK RF art. 337 (“[A] pledge shall secure . . . the compensation of the necessary expenses of the creditor for the maintenance of the collateral and expenses for recovery.”).

95. Schwartz, *supra* note 93, at 127. Another detailed mathematical proof accompanies this proposal. *See id.* at 127-28.

96. Consider also Professor Kripke’s misgivings about the value-protecting function of public disposition, *infra* note 121.

97. *See generally* BFP v. Resolution Trust Corp., 114 S. Ct. 1757 (1994) (discussing “reasonably equivalent value” for foreclosed real property).

98. *See, e.g.*, United States v. Cartwright, 411 U.S. 546, 551 (1973) (noting that this test is “nearly as old as the federal income, estate, and gift taxes themselves”).

a fair market value for any given item, and the difficulty is enhanced when the law compels the seller to use an inefficient public auction. .

The vultures that hover around public auction grounds all have the same goal in mind: bid just enough to outdo the miser across the way, but in any case keep the bid as low as possible to walk away with a bargain piece of merchandise.<sup>99</sup> No one can divine the price that any particular group of bidders assembled at the auction block will be willing to pay for the collateral, particularly in remote regions where the value of money is greater and the bidders are less familiar with such sales than in the commercial centers.<sup>100</sup> The function of the public auction for the participants is certainly not to provide the debtor with the protection of a fair price; on the contrary, the bidders want to take the collateral for as little as possible, and they know that the cards are already stacked in their favor by virtue of the circumstances of a forced disposal.<sup>101</sup>

Finally, one might challenge the hypothetical vast surplus that the creditor supposedly lazily denies to the debtor upon hurried sale of the collateral. Experience has shown that any surplus to be returned to the debtor simply is not the norm for foreclosure sales; the concern of every creditor is avoiding the expected deficiency.<sup>102</sup> Even in the rare case when the creditor obtains a surplus from disposition of the collat-

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99. Grant Gilmore characterized the typical assembly of bidders at public foreclosure auctions as being "about as lively as a group of mourners at a funeral." GILMORE, *supra* note 11, § 44.6, at 1242; *see also* United States v. Conrad Publishing Co., 589 F.2d 949 (8th Cir. 1978). The majority in *Conrad* rejected a public auction based partly on its feeling that it had been poorly attended and that the few bidders who did attend showed little interest in the particular printing equipment being sold. *See* 589 F.2d at 951-52. The dissenting judge, however, retorted that while "only" 118 bidders attended the auction, "the majority fails to recognize that in a typical sale of foreclosed property one hundred sixteen fewer would have attended." 589 F.2d at 956 (Gibson, C.J., dissenting). The dissenter remarked that the "number far exceeds the minimum to be expected at a reasonably run auction of distressed goods." 589 F.2d at 956.

100. The accounts receivable of a large oil enterprise, for example, would sell for significantly more on a Moscow market than at a general public auction in remote Nizhnevartovsk. *See also* 2 ALAUZET, *supra* note 8, § 795, at 204 (discussing the superiority of Paris as a market for "diamonds or other objects that can be sold well only in Paris"). For an example of one lawyer's attempted reliance on a more conservative, rural economic perspective to avoid an anticipated greater valuation of damages by a New York jury, *see* Gulf Oil v. Gilbert, 330 U.S. 501 (1946).

101. Private negotiation would much more readily allow the seller to conceal from potential buyers the fact of forced liquidation, allowing the seller to obtain a more reasonable return.

102. Recall the somber observation of Gilmore that "[t]he surplus to be returned to the debtor after the sale is a glittering mirage; the deficiency judgment is the grim reality." GILMORE, *supra* note 11, § 43.2, at 1188. Gilmore continues by pointing out that "nine times out of ten," the creditor is the ultimate purchaser of the collateral and "pays not in cash but by a credit against the debt." *Id.* § 43.2, at 1188-89. This lends



eral, it would be more efficient to control the occasional abusive creditor by some sort of judicial scrutiny of the resale procedure rather than by encumbering all resales with the public auction requirement.<sup>103</sup>

Even more so than their counterparts in North America or Europe, creditors in Russia have a vested interest in immediately maximizing the return upon disposition of collateral. Conditions in Russia place significant obstacles in the way of any creditor considering playing the market to evade her responsibilities to the debtor. The Russian market lacks consistent indicators that might allow the creditor to rely on obtaining any certain price for the collateral; to avoid great risk, she must pursue the disposition mechanism with the greatest potential for return. If a deficiency remains, the creditor will be hard pressed to obtain full repayment from a debtor teetering on the verge of bankruptcy. Especially in the dynamic Russian economy, "public policy should no longer be made on the *assumption* that creditors do not maximize; the assumption must be the other way."<sup>104</sup>

## 2. *Specific Potential for Abuse in the Russian Sale Procedure*

The procedures prescribed by Russian law for conducting the auction increase the potential for abusive creditor tactics. In fact, they place the debtor in a substantially worse position than if the initial realization procedure allowed for greater flexibility. By waiting until the situation becomes critical, the creditor can appropriate the devalued collateral and realize a premium by reselling the collateral later. This danger exists in more liberal systems as well, but the Russian system seems to encourage such an outcome and lacks a ready, built-in response to abuse.

Creditors have exploited the realization mechanism in the United States also, and Professors White and Summers offer a caveat to debtors to be vigilant to such abuses:

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even more urgency to the misgivings about the Russian public auction procedure described *infra* section II.B.2.

103. See, e.g., 2 ALAUZET, *supra* note 8, § 793 (defending the greater freedom given to the creditor by the French Commercial Code by noting that "all things may offer the potential for abuse," but explaining that the legislators could not "sacrifice a principle of a great and incontestable utility, in the majority of cases, to entirely exceptional circumstances"); CIS CONFERENCE, *supra* note 8, at 58 (comments of Professor Breidenbach observing that an obligation for the creditor to act reasonably and to pay reparations for acting unreasonably provides sufficient protection to the debtor); Schwartz, *supra* note 93, at 124 ("Article 9 of the UCC apparently responds intelligently to the occasional cases of creditors' venality or sloth that will inevitably arise.").

104. Schwartz, *supra* note 93, at 139.

[S]ome secured creditors will be tempted first to hold a procedurally proper public sale where they buy the goods themselves for rather less (perhaps *much* less) than a private sale would have brought, and thereafter resell at a higher price through their private outlet — the outlet through which they would have conducted a private sale had they done so in the first place.<sup>105</sup>

Given a spiritless and poorly attended public auction, the creditor has every incentive to “succumb[] to the natural temptation of ‘buying’ the property from himself at a fraction of its fair value.”<sup>106</sup> But the “commercially reasonable” standard of the North American systems<sup>107</sup> acts as the necessary disincentive to such schemes and allows the debtor to challenge this sort of manipulation.

The Russian law lacks any such explicit remedy. Under the current Code, avaricious creditors might exploit the abusive opportunity to reap a double benefit from the collateral in at least two ways. First, creditors certainly could apply to the Russian system the buy-and-resell scheme against which White and Summers forewarn. The creditor may bid at the auction, and as long as one more person appeared at the auction (perhaps someone enticed by the creditor) and either of them raised the initial bidding price by so much as a ruble,<sup>108</sup> the creditor could walk away from the auction with a bargain piece of collateral that might be sold subsequently in a different market under more conducive conditions for significantly more money. The debtor would remain liable for

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105. 4 WHITE & SUMMERS, *supra* note 31, § 34-11; *see also In re Zsa Zsa Ltd.*, 352 F. Supp. 665, 671 (S.D.N.Y. 1972) (noting that judicial scrutiny of the auction price compared to estimated value is “especially appropriate where self dealing is alleged”), *aff’d.*, 475 F.2d 1393 (2d Cir. 1973). In one particularly egregious case of a creditor buy-low-sell-high scheme, the creditor bought the collateral at public auction for \$155,000 and then transferred it to a private party with whom he had concluded a contract in advance to resell the collateral for \$950,000. *See Boender v. Chicago North Clubhouse Assn.*, 608 N.E.2d 207 (Ill. App. 1992). The court noted that “[i]t is difficult to imagine a factual situation where self-dealing by the secured creditor is more apparent.” 608 N.E.2d at 212. A less shocking example appears in *Savage Constr. v. Challenge-Cook Bros.*, 714 P.2d 573 (Nev. 1986), similarly involving a prearranged resale to a third party by the creditor following public auction. There the numbers were not so disparate: \$158,000 auction price as compared to resale at \$193,000 (still, a tidy profit of \$35,000 to the crafty creditor convinced the court to remedy this situation as well). *See Savage Construction*, 714 P.2d at 574; *see also Connex Press, Inc. v. Intl. Airmotive, Inc.*, 436 F. Supp. 51, 53 (D.C. Cir. 1977) (aircraft purchased for \$325,000, resold for \$855,000); *Levers v. Rio King Land & Inv. Co.*, 560 P.2d 917, 918-19 (Nev. 1977) (ranch supplies purchased for \$100, resold for \$10,000); *Comett v. White Motor Corp.*, 209 N.W.2d 341 (Neb. 1973) (45 new garbage trucks purchased for \$382,500, resold after cleaning and repair for \$577,500).

106. GILMORE, *supra* note 11, § 44.6, at 1242.

107. *See infra* note 127 and section II.C.2.

108. *See supra* note 30 and accompanying text.

the deficiency,<sup>109</sup> and the creditor might receive a hefty windfall, depending upon the particular circumstances of the case.

Second, creditors can take advantage of the public-private price discrepancy even more efficiently under the Russian law by waiting until the auction fails. If the debtor somehow convinces the creditor to agree to a relatively high initial bidding price, the creditor can smile and wait for the auction to take place. When no bidders show up, or if those few bidders who do appear balk at the price, and the auction is declared void, the creditor can blithely refuse to take the collateral at the asking price and await a second auction.<sup>110</sup> When the second auction again proves fruitless, the creditor can take the collateral at a ten percent discount and return to any remaining assets of the debtor for any deficiency.<sup>111</sup> This statutory scheme produces the same result as the bidding scenario described above, but the creditor is not even inconvenienced with the burden of bidding. She can simply bide her time if she feels that public auction at the agreed price is futile. As soon as the debtor ambles into the trap, the creditor snaps the door closed, taking the debtor for a possible deficiency and reselling the ill-gotten gain later for a tidy profit.

While judicial scrutiny may remedy some instances of this abuse, it is not clear that this practice is even prohibited by Russian law. Allowing the creditor to proceed directly to a private sale, while imposing a duty to justify that procedure, would better combat the potential ill effects of manipulation of the sale.

### C. *The Lessons of North American History and Practice*

This section focuses on the process in North America of searching for and choosing a realization mechanism that most efficiently and equitably balances debtor protection and creditor discretion. It submits that the U.S. commercial law experts who drafted Article 9 of the Uniform Commercial Code ("Article 9"), as well as the Canadian lawmakers who subsequently adopted almost identical provisions, relied on compelling grounds in allowing the creditor greater flexibility in disposing of the collateral. Drawing on the insight and experience of American courts and commentators, this section also exposes the pitfalls of actual practice with public auctions of collateral. While Russia's economic situation is clearly unique, the concerns of secured lenders and the components of a successful system of security are the same in

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109. See GK RF art. 350(5).

110. See *supra* notes 30, 33 and accompanying text.

111. See *supra* note 34 and accompanying text.

almost any context — including Russia today. Section II.C.1 recalls the predecessor acts that were the focus of the drafting process of the default section of Article 9, placing particular emphasis on the reasoning that motivated the drafters' choice of flexible disposal provisions from among many such norms available at the time. This examination is supplemented by a brief discussion of the Canadian decision to adopt disposition provisions very similar to those in Article 9. Section II.C.2 demonstrates the unfortunate reality of allowing creditors to rely on public auction to the detriment of debtors. It examines U.S. judicial experience that has shown that public auction is sometimes a commercially unreasonable means of producing an optimal return from collateral. Section II.C.3 concludes with some final challenges to the expediency of public auction.

### 1. *The Central Choice in the Development of an American Realization Mechanism*

The liberal provisions for realization of repossessed collateral in Part 5 of Article 9 represent the fruits of an arduous process of comparing the various components comprising the previous, disjointed law of secured transactions in the United States. When the Uniform Commissioners undertook the task of formulating a standard norm to be applied to the disposition of collateral after default, they narrowed their options to two opposing paradigms from previous uniform acts.<sup>112</sup> On the one hand, the Uniform Conditional Sales Act insisted on sale of the goods at public auction and prescribed an elaborate procedure of notices, locations, and time periods for conducting the auction.<sup>113</sup> The realization provisions of the Uniform Conditional Sales Act in many ways resemble the modern limitations previously described.

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112. See U.C.C. § 9-504 cmt. 1 (1990).

113. See UNIF. CONDITIONAL SALES ACT § 19, Commissioners' Note (withdrawn 1943), 2 U.L.A. 30-31 (1922); COMMENTARIES ON CONDITIONAL SALES, 2A U.L.A. § 117 (1924). One should note particularly that § 19 of the U.C.S.A. prescribed public auction only when the debtor had already paid 50% of the purchase price of the goods. "If he ha[d] paid less, statistics show[ed] that nothing is realized for the buyer on a resale. The depreciation of the goods more than eats up the buyer's equity. Where there is no chance of benefiting the buyer, a compulsory resale is a useless and expensive formality." UNIF. CONDITIONAL SALES ACT § 19, commissioners' note, 2 U.L.A. 34 (1922). Under § 20 of the Act, the buyer could always demand a resale, even if she had only paid an insignificant portion of the purchase price, but the Commissioners considered it "undesirable to require such resale as a matter of law in cases where business experience shows that it can do no good." UNIF. CONDITIONAL SALES ACT § 19, commissioners' note, 2 U.L.A. 34 (1922). Thus, the requirement of public auction was looked upon only with reserved favor even at its prime in American law.

Standing on the opposite end of the spectrum, the Uniform Trust Receipts Act allowed the creditor much more freedom to choose the most efficient realization mechanism.<sup>114</sup> The drafters of the Uniform Trust Receipts Act believed that the provisions for obliging the creditor to return to the debtor any surplus from the sale adequately “preserve[d] the [debtor’s] protection against forfeiting his equity of redemption.”<sup>115</sup> Most importantly, the drafters asserted that “by simplifying the procedure and giving certainty of security, the Act cheapens the dealer’s financing, which in turn redounds to the benefit of the consuming public.”<sup>116</sup>

The functionality and freedom of the Trust Receipts Act eventually emerged as the choice for the new Article 9, and the comments of two prominent scholars closely connected with the drafting effort explain this result. First, Harold Birbaum, who acted as advisor to the reporters for Article 9, rejected the notion that the flexible option chosen was unduly favorable to secured creditors.<sup>117</sup> He defended the loosening of restrictions by pointing to the desired benefits of eliminating “wasteful expenses” connected with secured lending and ultimately reducing the cost of secured credit to the consuming public.<sup>118</sup> Birbaum counted this

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114. Upon default, the creditor could take possession of and was then empowered to sell the goods, documents, or instruments covered by the trust receipt “at public or private sale.” UNIF. TRUST RECEIPTS ACT § 6(3)(b) (withdrawn 1951), 9C U.L.A. 247 (1957). The creditor was obligated to account to the debtor for any surplus from the sale remaining after payment of the debt, but she retained the right subsequently to claim a deficiency if the proceeds fell short of the amount owed. *See* UNIF. TRUST RECEIPTS ACT § 6(3)(b) (withdrawn 1951), 9C U.L.A. 247 (1957).

115. UNIF. TRUST RECEIPTS ACT, Commissioners’ Prefatory Note, 9C U.L.A. 226 (1957).

116. UNIF. TRUST RECEIPTS ACT, Commissioners’ Prefatory Note, 9C U.L.A. 226 (1957). The Commissioners further asserted that “[t]he Act works to the interest of trust receipt financiers . . . by making their foreclosure procedure clear and workable,” while it “works to the interest of trust receipt borrowers . . . by cheapening their financing, [and] increasing the realization on security at foreclosure sale.” UNIF. TRUST RECEIPTS ACT, Commissioners’ Prefatory Note, 9C U.L.A. 229 (1957).

117. *See* Harold F. Birbaum, *Article 9 — A Restatement and Revision of Chattel Security*, 1952 WIS. L. REV. 348, 389-90.

118. *See id.*; *see also* Schwartz, *supra* note 93, at 117 (“Consumers who grant security interests to creditors pay lower interest rates in return . . .”); *infra* note 129.

Birbaum’s comments reflect the policy struggle to which the disposition provisions of Article 9 responded. The drafters attempted to achieve the elusive and delicate balance between two policy positions: “one, a desire to impede dishonest dispositions, and the other, a reluctance to strangle honest transactions with red tape.” Hogan, *supra* note 25, at 220; *see also* Grant Gilmore, *Article 9 of the Uniform Commercial Code — Part V: Default*, 7 CONF. ON PERS. FIN. L.Q. REP. 4, 7 (1952) (describing the goal of avoiding either of two extremes: “setting the barriers against fraud so high that legitimate business operations are blocked . . . [or] setting them so low that fraud flourishes unchecked”). *But see* CIS CONFERENCE, *supra* note 8, at 106 (comments of Aleksandr

enhanced flexibility among the major advances of Article 9. He recognized that “[t]he rigid formality of old-fashioned foreclosures has often resulted in loss to all except those who purchased at foreclosure sales.”<sup>119</sup>

Second, Grant Gilmore, a preeminent scholar of personal property security in the United States and Associate Reporter for Article 9, expressed his even greater conviction that more liberal realization provisions were superior to the old limited mechanisms.<sup>120</sup> Gilmore challenged the Uniform Conditional Sales Act’s insistence on public auction, declaring that it “guarant[eed] that the property would go for less than it was worth.”<sup>121</sup> Gilmore emphasized his “firmly held belief” that requirements like the Russian public auction provision “make it impossible to dispose of the collateral at a decent price.”<sup>122</sup> While recognizing that the limitations were designed with protection of the debtor in mind, Gilmore lamented the fact that “the cure . . . [had] proved worse than the disease.”<sup>123</sup>

Moreover, Gilmore challenged the effectiveness of public auction in preventing fraud. He insisted that rigid statutory procedures, like the

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Makovskii outlining his concerns about the untoward effects of foreclosures on consumers who might “end up as a practical matter with absolutely nothing, thrown out onto the street”).

119. Birnbaum, *supra* note 117, at 390; *see also* Davenport, *supra* note 91, at 306 (“Much of the credit for [the complete taking hold of Article 9] must go to the flexibility of the Code provisions.”).

120. *See* Grant Gilmore, *The Secured Transactions Article of the Commercial Code*, 16 LAW & CONTEMP. PROBS. 27 (1951).

121. Gilmore, *supra* note 118, at 7. Compare Gilmore’s appraisal with the comments of Homer Kripke, a former member of the Subcommittee of the American Law Institute on Article 9: “Everybody knows in practice that public sales are usually perfunctory, and nobody bids but the creditor.” Homer Kripke, *Kentucky Modernizes the Law of Chattel Security*, 48 KY. L.J. 369, 386 (1960).

Moreover, Kripke questions the very necessity of a foreclosure and sale if the supposed value in the collateral to be protected by public auction actually exists. If the debtor expected to reap any significant gain from the sale of the collateral, Kripke argues, the debtor would not leave the details of the sale to the creditor. She would sell the goods herself to avoid default and completely escape any danger of creditor negligence, or the debtor would find substitute financing using the valuable collateral as security. *See id.* The debtor’s inability to rely on either of these escape devices shows that the value expected from a general offering to the public in the area where the debtor has been conducting business all along likely will not produce any excess return.

122. Gilmore, *supra* note 120, at 43.

123. *Id.* Despite Gilmore’s seemingly strong aversion to public auction, he initially backed away from this position by indicating that the creditor might always permissibly choose public auction over private sale. *See* Gilmore, *supra* note 118, at 10. Later, though, after another prominent commentator challenged this proposition, Gilmore recanted and recognized that the challenger was “obviously right” about public auction potentially failing the commercial reasonableness test. *See* GILMORE, *supra* note 11, § 44.6, at 1245 & n.12.

requirement of public auction, have always been and will always be incapable of preventing actual fraud: "On the rockiest ledge, in the tiniest cranny, through the most nearly invisible loophole, fraud knows how to flourish luxuriantly. This is disquieting but true."<sup>124</sup> Public auction proceedings, Gilmore explained, are commonly dominated by "local gangs of thieves" who appropriate the collateral through collusive bidding arrangements only to "grow fat" later by selling their ill-gotten gain on a more conducive market.<sup>125</sup> Far from accomplishing its goal of debtor protection, the public auction requirement in fact shifts the benefit away from the debtor to those who least deserve it.

Eventually, lawmakers in several of the Canadian provinces recognized the potential benefits to debtors and creditors of the flexible approach taken by their southern neighbor, so they enacted the Personal Property Security Act ("PPSA").<sup>126</sup> The disposition provisions of the PPSA track those in Article 9.<sup>127</sup> Just as in the United States, the Canadian drafters chose this "simple, efficient, and flexible tool" and rejected any rigid requirement of public auction on the assumption that private sales by way of regular commercial channels would protect the interests of both debtors and creditors by producing greater returns than public auction would.<sup>128</sup>

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124. Gilmore, *supra* note 120, at 44. Compare this skeptical appraisal with the averment of Boileux concerning the capacity of the law to uncover fraud. *See supra* note 89 and accompanying text.

125. *See* Gilmore, *supra* note 120, at 43; *see also supra* notes 105-11, 119 and accompanying text.

126. R.S.O., ch. P.10 (1990) (Ont.). Since the provisions of the PPSA have undergone only slight alterations in subsequent adoptions by other provinces, this section focuses on the language appearing in the law of Ontario, the first province to enact the PPSA.

127. *See* Personal Property Security Act, R.S.O., ch. P.10, §§ 58-66 (1990). The PPSA permits the creditor to dispose of the collateral "by public sale, private sale, lease or otherwise and . . . may be made at any time and place and on any terms so long as every aspect of the disposition is commercially reasonable." Personal Property Security Act, R.S.O., ch. P.10, § 63(2) (1990).

128. *See* 2 RICHARD H. MCLAREN & KATHERINE DE JONG, SECURED TRANSACTIONS IN PERSONAL PROPERTY IN CANADA § 23.03[2] (Supp. 1986). Similar reform sentiments have been voiced on the other side of the border as well. Alejandro Garro delivered a particularly vehement attack on the public auction regime in the states of his native South America:

A fair determination of the parties' mutual rights does not have to suffer because of the need to dispose of the collateral in a costly and cumbersome public sale. Any collateral realization system which demands a sale by public auction is bound to work inefficiently. Most public sales are sparsely attended and consequently prices are notoriously low, to the detriment of both the secured creditor and the debtor. The obvious justification for requiring a sale by a public official is that the debtor is afforded some needed protection. But even this purpose is not

The malleable provisions of Article 9 and the PPSA have enjoyed success in North America because of their free adaptability to any situation, allowing the parties to arrive at the most acceptable means of reaping the benefit of their security agreement. The policymakers who formed these provisions shared the same concern for debtor protection that motivated Russian legislators to impose the public auction restriction. But the North American approach bestows the benefit from the disposition on the parties who deserve protection, rather than on bargain shoppers at public auction. The more flexible provisions acknowledge that an optimal return on collateral is the best form of protection for both parties.<sup>129</sup> U.S. and Canadian lawmakers recognized that regular commercial channels are predisposed to producing acceptable returns, and they feared that public auction most often produces just the opposite effect. But rather than make a rigid choice responsive to only one subset of transactions, the North American drafters left the choice to those familiar with the factors at hand at any given moment, including the particular conditions of the agreement, market conditions, and other similarly unpredictable contingencies. Lawmakers did not cede total control to the parties, as the next section demonstrates, but their compromise provides much-needed flexibility in modern commercial transactions in a rapidly and unpredictably changing market.

## 2. *Judicial Practice and Commercial Unreasonableness*

The drafters of Article 9 provided creditors with a flexible standard for realization of collateral, but they tempered this flexibility with an explicit protective requirement that “every aspect of the disposition including the method, manner, time, place and terms must be commer-

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accomplished because many of the public auctions are controlled by hired bidders who dominate the auction and restrain bidding.

Alejandro M. Garro, *Security Interests in Personal Property in Latin America: A Comparison with Article 9 and a Model for Reform*, 9 HOUS. J. INTL. L. 157, 235-36 (1987).

129. French lawmakers recognized the reciprocal benefits available to the debtor by protecting the creditor when they were adopting their new Commercial Code:

There is no doubt that . . . when every lender secured by commercial pledge will be sure of recovering his loan easily, without costs and on the appointed day, there will be a greater number of bankers and capitalists disposed to lend to commerce with the security of a pledge, and that they will lend at a more moderate rate of interest. One can thus say here that to favor the creditor is in fact to favor the debtor.

2 ALAUZET, *supra* note 8, § 792, at 199 (quoting the “orator of the Government” as he presented the proposed article 93 of the Commercial Code on commercial pledge to the French Legislative Body).



cially reasonable.”<sup>130</sup> Under this standard, even the very question of which type of sale to hold — public or private — falls within the ambit of the judicial inquiry, and practice has shown that public sales of collateral are not always reasonable. U.S. courts have gone so far as to proscribe public auction as an unacceptable evasion of the creditor’s commercial obligations to the debtor.

In the seminal case of *Old Colony Trust Co. v. Penrose Industries Corp.*,<sup>131</sup> the unique nature of the collateral posed difficulties for its effective disposition, and the uncooperative debtors consistently opposed any sort of sale.<sup>132</sup> The creditor initially considered the option of a public auction, but the “experienced advice” of an appraiser indicated that a private, negotiated sale would produce a better return.<sup>133</sup> The court concluded that private or “negotiated” sale may have been the only commercially reasonable option. Given that the debtors vehemently opposed any sale that they did not favor, the creditors had to conduct extensive negotiations of the terms of any contract to sell the collateral — a procedure that would have been impossible in a public disposition.<sup>134</sup>

While the *Old Colony Trust* court only hinted at the potential irrationality of public sale, two other courts subsequently solidified that principle. In *United States v. Terrey*<sup>135</sup> the creditor admitted that normally public auction was “the last resort for disposition.”<sup>136</sup> Nonetheless, ignoring private offers that exceeded the auctioneer’s estimate nearly sevenfold, the creditor proceeded to sell off the collateral piecemeal at a well-attended auction<sup>137</sup> for approximately one-fifth of the amount of the private offers.<sup>138</sup> Sale of one portion of the collateral

130. U.C.C. § 9-504(3) (1990). The same standard appears in the Canadian PPSA. See *supra* note 127 and accompanying text.

131. 280 F. Supp. 698 (E.D. Pa.), *aff’d.*, 398 F.2d 310 (3d Cir. 1968).

132. See 280 F. Supp. at 703. The collateral consisted of the common stock of a radio station. See 280 F. Supp. at 702-03.

133. See 280 F. Supp. at 704 n.7 (“Public bidding apparently depressed the value of a radio station until the closing because it adversely affected earnings by deterring advertising contracts and depressing employee morale.”).

134. See 280 F. Supp. at 713.

135. 554 F.2d 685 (5th Cir. 1977).

136. 554 F.2d at 689.

137. The publicity created by the “experienced auctioneer” whom the creditor had hired attracted a crowd of 106 bidders. See 554 F.2d at 690. It is particularly noteworthy that even with this substantial attendance and an experienced auctioneer, the sale produced an abnormally low return. Part of the problem was an auctioneer who was unfamiliar with the collateral, who “did not know the difference in value between a ninety-cent optical coupler and a one-cent capacitor,” both of which comprised a significant portion of the collateral. 554 F.2d at 690. One can be sure that problems like these will be even more prevalent with a court officer conducting the sale.

138. See 554 F.2d at 690.

alone might have produced almost twice as much as the final auction return, and this factor, among others, influenced the court to return the case to the jury, who, the court thought, could reasonably have concluded that such a sale fell short of the standard of commercial reasonableness.<sup>139</sup> Subsequently, in *United States v. Willis*,<sup>140</sup> the court held that the assumption that public auction was inherently reasonable was “clearly false” and that the creditor had unreasonably chosen a public over a private sale in the circumstances.<sup>141</sup> In both *Terrey* and *Willis*, public auction simply did not, and likely could not, produce a return superior to that of a private disposition. Without the commercial reasonableness standard applied through judicial supervision of these sales, the debtors would have been the real victims in the end.

### 3. Concluding Challenges

Current Russian law fails to take into account significant variances in the marketability of various types of collateral, and it inhibits productive reliance on modern means of commerce. Public auction may well be the most efficient mechanism for disposing of certain kinds of collateral. For relatively fungible commodities that are widely traded at auctions, such as livestock<sup>142</sup> and moderate quantities of certain consumer goods, a local auction may be a completely appropriate means of realizing an acceptable return on the collateral. The option of conducting a public auction when such a mechanism is appropriate should endure.<sup>143</sup>

Many other categories of collateral, on the other hand, are particularly poor candidates for public auction and logically should be disposed of privately. This group includes such common collateral items as

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139. See 554 F.2d at 695-96.

140. 593 F.2d 247 (6th Cir. 1979).

141. See 593 F.2d at 258-59. The creditor had received private offers for the collateral for significantly more than both the amount initially estimated by the auctioneer and the amount actually realized at the auction. See 593 F.2d at 250, 259.

142. See BARKLEY CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* ¶ 4.08[2] (2d ed. 1988); Davenport, *supra* note 91, at 285.

143. Even in situations in which public auctions are appropriate, the proper forum for the sale is not the courthouse steps. An experienced auctioneer should conduct the proceedings, not a moonlighting court officer. U.S. courts have invalidated auctions and reproached creditors for failing to retain experienced auctioneers. See, e.g., *Liberty Natl. Bank & Trust Co. of Okla. City v. Acme Tool Div. of the Rucker Co.*, 540 F.2d 1375, 1381-82 (10th Cir. 1976). Creditors should be allowed to take advantage of at least this simple value-adding factor. The benefit derived from professional handling of the sale will, in most cases, far outweigh any slight increase in procedural costs.

large factory equipment,<sup>144</sup> oil rigs,<sup>145</sup> and large quantities of most sorts of inventory<sup>146</sup> that simply would not find an appropriate buyer at the average public auction. More exotic collateral and goods that appeal only to a particular discrete group of potential buyers, such as Lear jets,<sup>147</sup> specialized inventory,<sup>148</sup> and specialized farm and other equipment,<sup>149</sup> are all the more ill-suited to liquidation through general public offering. As one U.S. court has observed, "it is obvious that in disposing of unique collateral the secured party must make significant attempts to reach the most logical purchasers."<sup>150</sup> If legislators truly wish to protect the debtor, they should permit the creditor to utilize the most reliable means possible of profitably disposing of these items. In many,

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144. See, for example, *United States v. Conrad Publishing Co.*, 589 F.2d 949 (8th Cir. 1978) (printing equipment, including presses, cameras, stitchers, etc.).

145. See, e.g., *Liberty Natl. Bank & Trust Co. v. Acme Tool Div. of the Rucker Co.*, 540 F.2d 1375 (10th Cir. 1976).

146. See, e.g., *Ace Parts & Distribs. v. First Natl. Bank of Atlanta*, 245 S.E.2d 314, 315 (Ga. Ct. App. 1978) ("thousands upon thousands of automobile parts"); *Chrysler Credit Corp. v. B.J.M., Jr., Inc.*, 834 F. Supp. 813 (E.D. Pa. 1993), *affd.*, 30 F.3d 1485 (3d Cir. 1994). One might think that a public auction of the inventory of a car dealership would attract many eager buyers who would be willing to pay a fair amount for a new automobile. But the court in *Chrysler Credit* acknowledged the sage advice of a marketing expert who explained that Chrysler Credit had consistently sold repossessed vehicles at limited dealer-only auctions, "and they usually [got] more for the vehicles when they [sold] at a Chrysler-dealers only auction." 834 F. Supp. at 835; see also *Lloyd's Plan, Inc. v. Brown*, 268 N.W.2d 192 (Iowa 1978). In *Lloyd's Plan*, the creditor repossessed an automobile, advertised it publicly, and received offers of \$2475 and \$2895. Finally, though, it sold the automobile privately to its manager's secretary for \$3400. See 268 N.W.2d at 193.

147. See, e.g., *In re Frazier*, 93 B.R. 366 (Bankr. M.D. Tenn. 1988). The court here emphasizes that "[p]rocedures employed to sell small jet aircraft are matters particularly within the knowledge of a small group of persons who are experts in the highly technical endeavor." 93 B.R. at 368-69. The creditor should have relied on a "limited pool of qualified commercial buyers" in order to remain within prevailing responsible practice rather than the concededly "last resort" method of public auction. See 93 B.R. at 370; see also *Connex Press v. International Airmotive*, 436 F. Supp. 51 (D.D.C. 1977). While *Connex Press* involved a larger aircraft, the same problems arose, given that "[p]lanes of this type had never been sold at public auction." 436 F. Supp. at 55.

148. See, e.g., *Trimble v. Sonitrol of Memphis*, 723 S.W.2d 633, 641 (Tenn. Ct. App. 1986) (security systems "salable only to the Sonitrol dealer network").

149. See, e.g., *AgriStor Credit Corp. v. Radtke*, 356 N.W.2d 856, 861 (Neb. 1984) ("[T]he best method to resell Harvestores [feed silos] was through a Harvestore agency because ultimate reuse or resale requires dismantling, repair, new parts, and new assembling that all required special equipment. Public sales produced poor results."); *Associates Capital Servs. Corp. v. Riccardi*, 454 F. Supp. 832, 833 (D.R.I. 1978) ("unique equipment" consisting of "a system of two-way communications components").

150. *Pippin Way, Inc. v. Four Star Music Co. (In re Four Star Music Co.)*, 2 B.R. 454, 462 (Bankr. M.D. Tenn. 1979).

if not most, instances, this will involve some sort of private, negotiated sale.

Many of these sales should be accomplished with the assistance of the mechanisms already in place with the resources and experience to handle particular sales in the most efficient manner.<sup>151</sup> For example, precious metals, gems,<sup>152</sup> and securities,<sup>153</sup> likely to become increasingly common sources of collateral in Russia, should be sold through exchanges, where the forced nature of the sale can be hidden to avoid an adverse effect on the value, and where experienced sellers combine with sophisticated buyers to arrive at the most favorable price on the market at any given time.<sup>154</sup>

Finally, with the aid of modern technology, private negotiation can exploit markets far removed from the place of the collateral to secure a significantly better price. Willing buyers may not want to take the long and expensive trip from, for example, Moscow to Krasnoyarsk or Vladivostok to attend an auction. These potential buyers may offer terms of sale through private negotiation by phone, fax, and so on, that significantly eclipse the run-of-the-mill bid at public auction. This should be particularly so in the case of collateral that appeals to a limited class of

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151. See *supra* text accompanying notes 43-46.

152. See Alexander Kim, *Foreign Firms Are Not Rushing Into Yakutiya But They Have Their Eye On Her*, RESPUBLIKA SAKHA, Mar. 1, 1995, at 2, available in LEXIS, Busfin Library, SBE File (discussing the complexities associated with pledging precious metals and gems).

153. In the United States, serious complications may accompany public auctions of the myriad forms of unregistered securities that might be pledged to secure debt, particularly commercial debt. Public auction of such securities might fall under the definition of a "public offering" in § 5 of the American Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994), in which case the expense of preparing the required documentation might destroy any possible return on the securities. See Peter F. Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 521 & n.108 (1973); Davenport, *supra* note 91, at 294. For case treatment of this issue, see, for example, *United States v. Custer Channel Wing Corp.*, 376 F.2d 675, 676 (4th Cir. 1967); *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir. 1960). While this problem might be unique to the broad American securities laws, one should remain aware of the possibility of such a problem in developing securities laws in other countries like Russia.

154. Moving the burden of resale from lenders, whose expertise and facilities are normally limited to lending, to dealers, who possess the knowledge and resources to effectuate productive sales, apparently figured prominently in the U.S. drafters' decision to abandon strict adherence to public auctions. See U.C.C. § 9-507 cmt. 2 (1990) ("One recognized method of disposing of repossessed collateral is for the secured party to sell the collateral to or through a dealer — a method which in the long run may realize better average returns since the secured party does not usually maintain his own facilities for making such sales.").

purchasers. The higher price achieved through private, long-distance negotiation would clearly benefit both the creditor and the debtor.<sup>155</sup>

In conclusion, it seems highly unlikely that public auctions in Europe or Russia offer better potential for high returns than in the United States. Moreover, the general weaknesses and potential for abuse of the public auction mechanism are exacerbated by the dangers implicit in the current Russian procedure for conducting the sale.<sup>156</sup> Russian lawmakers should alter in some way the present system of obligatory public auction and restricted access to commercial markets to avoid the clear potential for problems more far-ranging than those that disquieted lawmakers originally.

### III. PROPOSED ALTERNATIVES TO THE CURRENT REGIME

This Part argues that something closer to the North American approach of optimal creditor freedom controlled by judicial review best serves the interests of all concerned parties. While problems of the standard of judicial review will require serious analysis and resolution of difficult problems, legislators ought to fulfill their responsibilities to their constituents by providing recourse to the most productive disposition arrangement available.

Russian reformers might choose from among a number of intermediate stages between the present law and the more liberal North American system. First, the law might provide greater independence to the parties. Rather than forcing the debtor and creditor to observe the public auction restrictions regardless of their wishes, the law could allow the parties to agree upon an alternate form of disposition after conclusion of the security agreement. This option exists in one form or another in all of the European systems analyzed above.

Whether the parties conclude such an agreement before or after default, however, conservative critics might fear significant creditor pressure on the debtor to accede to the creditor's will.<sup>157</sup> But despite the minor differences in the debtor-creditor relationship before and after default, it makes little difference when the parties are permitted to dero-

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155. The Russian procedural law permits the parties to transport the collateral to another, more suitable location for auction as one way of accomplishing a similar result. See GPK RSFSR art. 398. This option, however, requires the mutual consent of the parties, who must bear the expense of transporting the collateral to the alternate location. See GPK RSFSR art. 398. Moreover, even if the collateral can be relocated, it still must be sold by public auction, with no opportunity to negotiate more favorable terms with a private purchaser.

156. See *supra* section II.B.2.

157. The drafters of the Code Napoléon, for instance, were wary of creditor influence before default, but not after. See *supra* notes 54-55 and accompanying text.

gate from the norm. As soon as the debtor takes possession of the loan, the bargaining positions of the parties change fundamentally. The debtor no longer finds herself at the mercy of the creditor; on the contrary, it is the creditor who finds herself in a risky position. The creditor cannot place inordinate pressure on the debtor before default because she cannot legally foreclose before then. The creditor might threaten the debtor before default that every minor divergence from the agreement will result not in renegotiation or cooperation by the creditor, but rather in immediate foreclosure.<sup>158</sup> But foreclosure is most often not in the interest of the creditor in any event. The only real leverage that the creditor can apply after conclusion of the agreement and transfer of the loan funds is the loss of future goodwill or, more precisely, fear that the creditor will withhold loan funds in the future. Yet this is the case after default as well. As a first step, permitting any sort of agreement between the parties that allows them to diverge from the general rule of public sale introduces a bit more welcome flexibility into the realization procedure.

This first hesitant step of countenancing debtor-creditor agreement, however, is both too restrictive and perhaps too permissive. If the creditor presents to the debtor a plan to dispose of the collateral to a private party through negotiated sale, and if the creditor can prove a significant likelihood of inferior return from public auction, why should the law allow an intransigent, unsophisticated, or simply foolish debtor irrationally to refuse such an option? What if, for instance, a bankrupt debtor finds herself so far in debt to other creditors that she could care less about the return to be gained from the collateral? A surplus will not inure to the debtor's benefit; it will simply trickle off to the remaining creditors, and a subsequent deficiency claim will rank lower than all of the other claims against which the debtor has sought protection in bankruptcy. The desire of the creditor to squeeze out as much value from the collateral as possible is of no great concern to this insolvent and indifferent debtor. Permitting the debtor in this instance to inhibit the creditor's good faith efforts to seek out the most lucrative return on the collateral would be inefficient and unjust. On the other hand, it is no more acceptable to allow the creditor to exert on the debtor some sort of undesirable influence based on the creditor's superior bargaining position. One should at least provide for judicial scrutiny of the agreement process.

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158. See, e.g., PONT, *supra* note 54, § 1157. Professor Coogan also alludes to the convincing force of such implicit creditor coercion: "The debtor's agreement after default . . . is not likely to be given without his knowing on which side his bread is buttered." Coogan, *supra* note 153, at 523.

A second potential step by Russian reformers toward a more North American-like system adds the court to the picture: the law might permit the creditor to choose to bypass the debtor and petition the court directly for authorization to pursue a desired alternate course of disposition. Even this approach, though, has its faults. If the creditor in fact finds a more lucrative means of realizing on the collateral, especially when such disposition would result in no deficiency or even a surplus, the vast majority of debtors would feel fortunate that they escaped virtually unscathed after default.<sup>159</sup> If all creditors who met with debtor intransigence had to get a judicial declaration for such instances, many cases that would otherwise eventually have been settled amicably without the involvement of the court will now needlessly clutter the judicial docket. This will force the parties to incur unnecessary and deleterious transaction costs, including not only direct court costs, but also lost opportunity costs for wasteful diversion of time and other resources. The concept of taking security exists in large part precisely to avoid costly recourse to the court following default. Moreover, since the return from the collateral will now be used to defray the additional court costs, a deficiency may arise that might have been avoided without court involvement. Although permitting the court to place its imprimatur on alternate dispositions is certainly superior to blind, rigid, and ineffective public auction requirements, the parties' rights might be protected more efficiently if court involvement were limited to those instances where it was actually necessary.<sup>160</sup>

If Russian reformers agree that each of these previous steps improves the situation slightly but not enough, the final step toward balancing debtor and creditor interests brings the lawmakers to something closer to the North American approach. The law should allow the creditor to choose freely how to dispose of the collateral, but it should require her to justify that disposition if the debtor feels dissatisfied. This approach represents the best available alternative despite the monitoring costs associated with judicial "reasonability" review of the creditor's

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159. See, e.g., White, *supra* note 25, at 867 ("The normal business debtor is not seeking a court ordered foreclosure with its attendant costs if a smaller deficiency upon resale will be realized by a private sale or eliminated entirely by an acceptance of the collateral as satisfaction for the indebtedness or obligation.").

160. If the creditor wishes to dispose of the collateral in a certain way, yet feels unsure about the commercial reasonableness of that disposition, she should be allowed to rely on a declarative judgment. Article 9, for example, protects the creditor with a conclusive presumption of commercial reasonableness for dispositions that have been "approved in any judicial proceeding or by any bona fide creditors' committee or representative of creditors." U.C.C. § 9-507(2) (1990). If the creditor chooses to seek refuge in the court, the law should not discourage or deny such an exercise of prudent caution.

choice.<sup>161</sup> In most instances the rational debtor will be satisfied with the greater return that the shrewd creditor managed to acquire by way of an alternate, more lucrative realization mechanism. Additionally, by obviating the need to resort immediately to either initial agreement or court action, the parties will avoid needless transaction costs.

The law must maintain some check on creditor freedom, however, and the court can most efficiently play its guiding role at the final stage — if, and only if, complications arise. If for some reason the debtor feels that the creditor has disposed of the collateral in an unreasonable way, resulting in an unjust deficiency obligation, she should be able to seek the protection of the court. On the other hand, the creditor should be able to rely on a modicum of certainty and predictability when making what seems at the time to be an acceptable disposition. The creditor should not have to expend extra resources and heroic efforts finding the single most lucrative method of disposing of the collateral.<sup>162</sup> To this end, the law should contain some general guidelines to protect the reasonable expectations of the creditor.<sup>163</sup>

Part 5 of Article 9, while perhaps not wholly transferable to a developing legal system like that in Russia, should serve as a model for the development of optimally effective guidelines for the realization of collateral.<sup>164</sup> The law should provide for the greatest possible flexibility

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161. The monitoring costs in the United States have been significant. For just a few of the myriad cases and ample commentary dealing with the issue of judicial determination of commercial reasonableness, see the collection of materials on § 9-504 in 3B U.L.A. 127, 136-40, 212-55 (1992). These problems may well be complicated further by the overloaded and understaffed Russian court system. Nonetheless, American courts have faced similar problems, particularly in the large metropolitan areas where secured transactions litigation is most prevalent, and it is a more acceptable solution for legislators to attend to the pervasive problems in the court system than simply to capitulate to such challenges by restraining productive market flexibility.

162. See, e.g., GILMORE, *supra* note 11, § 44.5, at 1237 (“The secured party is not required to be a seer or a prophet. . . . He is required to act with due diligence, to use his best efforts . . .”).

163. For an example of the dangers of demanding too much from the creditor, see *Vetter v. Bank of Or.*, 591 P.2d 768 (Or. Ct. App. 1979). Gilmore considered that the law might have gone even further than the liberal allowances of Article 9, particularly in protecting the creditor’s choice of an alternate disposition mechanism. See GILMORE, *supra* note 11, § 44.6, at 1246. He expressed his confidence that if this section of Article 9 were redrafted, “it should be possible, with ingenuity, perseverance and luck, to take a longer step in the same direction.” *Id.*

164. It must be emphasized, however, that exact equivalence between Article 9 or the PPSA and the Russian law likely would not represent the best choice for Russian lawmakers, and this Note does not advocate such legal imperialism. This Note simply suggests that legislators should bear in mind the celebrated success of Article 9 when considering similar laws for their countries. Alejandro Garro, for example, advocates reforming the security interest laws of Latin American countries according to the model of Article 9. See Garro, *supra* note 128, at 199; Alejandro M. Garro, *The Reform and*



in the creditor's choice of a realization mechanism, be it by public or private sale or otherwise.<sup>165</sup> If the creditor can arrange for a truly more commercially reasonable disposition of the collateral, it seems counter-productive and illogical to refuse to permit the creditor to pursue such an option. The creditor should, however, notify the debtor of the final choice, permitting the debtor to protect her own best interests by fulfilling the secured obligation or purchasing the collateral herself. The onus of finding a reasonable means of disposition and possibly having to convince a court of its superiority, however, must remain with the creditor. This *quid pro quo* approach strikes the delicate balance between debtor and creditor interests and deserves serious consideration by any legislator wrestling with the problem of controlling the disposition of collateral.<sup>166</sup>

### CONCLUSION

Functional and rational laws providing a stable environment for investment will represent the first line of defense in adequately protecting

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*Harmonization of Personal Property Security Law in Latin America*, 59 REV. JUR. U.P.R. 1 (1990). While Latin America certainly is not identically situated with Russia, one can draw compelling analogies between the development of the Russian and Latin American economies.

165. The two most common forms of disposition "otherwise" than by sale would be leasing the collateral and allowing the creditor simply to retain the collateral in satisfaction of the debt. First, especially when the collateral had been leased before default, subsequent lease might produce the best return. See MCLAREN & DE JONG, *supra* note 128, § 23.03[2][a][i][A]; Thomas L. Rasnic, Comment, *Commercial Reasonableness Under the Uniform Commercial Code*, 33 TENN. L. REV. 211, 217 (1966). Such situations, however, will represent the exception rather than the norm. See Davenport, *supra* note 91, at 283; Brian Siegel, *The Commercially Reasonable Disposition of Collateral*, 80 COM. L.J. 67, 67 n.4 (1975).

Second, in some situations, the parties may both be better off without a resale. See U.C.C. § 9-505 cmt. 1 (1990); see also Hogan, *supra* note 25, at 215-19. Particularly if the collateral consists of commercial paper, accounts, and chattel paper (some of the most important sources of credit for most struggling small businesses), sale will normally produce less than collection and retention by the creditor.

166. This paradigm of liberal allowances to the creditor tempered by a judicial check has received the valuable endorsement of Professor Ulrich Drobniq of the Max Planck Institute for Foreign and Private International Law. See *Report of the Secretary-General: study on security interests*, in 8 UNCITRAL Y.B. 171, U.N. Doc. A/CN.9/131/1977. Professor Drobniq suggests that the only criterion for deciding how to conduct the disposition should be "the practical one, which of the two methods achieves the better results." *Id.* at 198. For other UNCITRAL examinations of worldwide security interest problems, see *Report of the Secretary-General: security interests; feasibility of uniform rules to be used in the financing of trade*, in 10 UNCITRAL Y.B. 81, U.N. Doc. A/CN.9/165/1979; *Report of the Secretary-General: security interests, issues to be considered in the preparation of uniform rules*, in 11 UNCITRAL Y.B. 89, U.N. Doc. A/CN.9/186/1980.

Russia's interests in the tremendous competition for capital in the world today. The practice of establishing security in property plays a central role in the general scheme of investor comfort; therefore, the law of secured transactions should be particularly sensitive to the needs of investors and borrowers alike. An effective realization mechanism lies at the heart of this law, ensuring the consistency and predictability that are so crucial to the parties concerned.

Russian legislators have produced a sophisticated framework with enormous potential for facilitating secured transactions, but they have simultaneously debilitated this impressive structure by inhibiting its crucial realization phase. Imposing a public auction limitation on the creditor's disposition of the collateral is a mistake founded on unstable policy grounds. First, while the successful commercial markets of Europe function adequately despite the same sort of restriction, each of the European states whose civil codes likely influenced Russia's reform effort has included explicit statutory language, narrowly construed the statutory language, or countenanced independent evasive techniques that mitigate the untoward effects of the public auction restriction. Second, creditors normally do not negligently devalue the collateral, and the public auction limitation actually worsens the debtor's predicament by ensuring a low return on the collateral: Finally, U.S. commercial experience has demonstrated the shortcomings of the institution of public auction.

In view of these problems, Russian legislators should institute a more flexible, responsive legal regime for scrutinizing the disposition of collateral. Providing access to the most effective means available for obtaining the maximum return from the collateral will shift the benefit from the denizens of public auctions to more appropriate recipients — debtors and creditors.

Formulating a workable standard by which to evaluate the disposition of collateral will demand hard thinking, much more so than the simple imposition of a clear and simple rule against all forms of disposition other than public auction. But relatively successful models already exist, and legislators owe it to their constituents to find the optimal solution to the problem of debtor-creditor relations after default. A simple limitation dating from the last century should not be allowed to persist simply based on its venerability. Public auction fails to perform the function for which it was designed, and such time-worn, reactionary rules should be replaced by more complex and sensitive standards that reflect the modern times to which they must adapt.