INSIGHT

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Arbitration in secured transactions

My exchange Last month with Michael Richter on my LinkedIn Blog Arbitration in Banking and Financial Matters prompted me to reflect on the advantages and limits of providing for an arbitration mechanism in secured financing. I am fortunate in being privy to two circles of reflection on this very topic organized under the aegis of two international organisations that are currently studying, separately, this topic. Hopefully, those reflections will soon mature and yield quality publications and reports. In the meantime, here are a few reflections.

It seems to me that the crux of the matter is not whether the grantor of the security right and the secured creditor are allowed to agree on the resolution by arbitration of any disputes arising under the security agreement. This is a contractual right that they enjoy based on the freedom of contract. The fact that a number of national laws, essentially in Latin America, refer explicitly to arbitration in relation to security rights adds little to this fundamental principle (see, e.g. the Model Inter-American Law on Secured Transactions Article 68: "Any controversy arising out of the interpretation and fulfillment of a security interest may be submitted to arbitration by the parties, acting by mutual agreement and according to the legislation applicable in this State.").

In warehouse financing (also a vastly used form of secured commodity financing in developing countries), the relationship between the grantor/depositor, the secured creditor/depositary and the warehouse is a matter of contract and, as such, arbitrable.

The question therefore really concerns the extent to which arbitration in relation to the security right, and the resulting enforcement on collateral, affects the rights of third parties, including other creditors. The following issues merit reflection.

First, let's accept that the relationship between the grantor and the secured creditor is a matter of contract and therefore can be the subject of an arbitration agreement. We can then contrast that to enforcement which raises proprietary issues that affect the rights of third parties and cannot, therefore, be resolved by arbitration. That said, to what extent may disputes arising in connection with out-of-court foreclosures by the creditor through, e.g. a foreclosure clause in the security agreement (French *pacte commissoire*), be resolved by arbitration?

I would suggest that we separate two types of issues here. First, those issues that relate solely to the grantor's agreement to allow self-appropriation by the secured creditor. Issues like consent, consideration, set-off, etc., are contractual and arbitrable. Second, a second type of issues that involves third

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parties' rights, such as a conflict of priority between the foreclosing creditor and other creditors. To the extent that any such issues arise, the matter should be deferred to a court of law which is not limited to the contractual jurisdiction of the arbitral tribunal and can address the issue of the rights of third parties. The question here is whether it is good justice to separate the disputed matter into clusters: one, arbitrable, covering the dispute between the grantor and the secured creditor as to enforcement and, a second one, covering the rights of third party arising out of that very enforcement. In practice, the two types of issues are inextricably intertwined. The court will have to walk a fine line between the statutory requirement to defer to the jurisdiction of the arbitral tribunal and its duty to adjudicate disputes that are outside the scope of such agreement.

Secondly, could the confidential nature of arbitration turn into a danger for the proprietary rights of secured creditors? Take the case where a judgment creditor moves to enforce on the collateral on the basis of a favorable award that was held to be enforceable in the place where the collateral is situated. Could the rights of a senior secured creditor on the same collateral be imperiled because of that enforcement action? Unlikely. The reason is that, while the arbitral proceeding in the matter of the debt recovery is confidential, the enforcement process on the collateral is public whether the collateral is under the control of the grantor, the creditor or a third party depositary or collateral manager. Outside case of self-help repossession or appropriation by the creditor, the enforcement process would take place before a court of law and to offer other secured creditors the necessary public information that allows them to intervene into the process to protect their rights. And in the case of self-help repossession, I do not believe that the rights of secured creditors other than the repossessing creditor are more in peril than where the repossession has resulted from a court judgment rather than an arbitral award. Indeed, a secured creditor that has become a judgment creditor is allowed to enforce its judgment on the collateral without a duty to publish a pre-enforcement notice to the attention of other potential creditors.

Other secured creditors who fail to monitor the collateral and realize that it has been repossessed by a junior creditor have a claim in restitution (a personal claim, not a proprietary one at least in civil law jurisdictions), and possibly tortious interference, against that creditor.

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