SECURITIES PROPERTY IN THE PHILIPPINES: A STATES COMMON LAW IMBROGLIO

I. Introduction

At the beginning of the twentieth century the commercial law of the Philippines, which had come to embody a synthesis of the Spanish civil law[1] and United States (hereafter 'US') common law,[2] was heralded as one of the most modern and progressive systems of law in the Asian region.[3] One example of the early infusion of US common law can be found in the field of law governing security over personal property,[4] where new security instruments were introduced by the then US Administration of the Philippines. This measure was deemed necessary in order to promote the economic design of the Administration, which was to transform the essentially agrarian economy of the

[1] In May 1889, the Spanish Civil Code was promulgated in Spain, and in July of the same year, by Royal Decree, it was extended to the Philippines; see FC Fisher, The Civil Code of Spain - With Philippines Notes and References, The Lawyer's Co-operative Publishing Co., Manila, Philippines & Rochester, New York, p v, (1918). Note, the Spanish occupation of the Philippines began in 1571 and ended in 1899, when it was ceded to the United States.

[2] See CS Lobingier, Blending Legal Systems in the Philippines, 21 *Law Quarterly Review* 401 (1905). See also MJ Gamboa, Introduction to the Philippine Law, Central Lawbook Company Publishing Co. Inc., Manila 7th ed, p 69 (1969) which cited Justice Malcolm's statement that, "There is in the Philippine islands a unique legal system in which the two great streams of law -the civil, the legacy of Rome to Spain, coming from the West, and the common law, the inheritance of the United States from Great Britain, amplified by American written law, coming from the East have met and blended."

[3] See Tolentino, *The Civil Code*, Central Lawbook Publishing Co. Inc., Manila, p 7 (1959).

[4] 'Personal property', for the purpose of this article, means tangible and intangible moveable property. For the definition of personal property, see Article 415 of the Philippines Civil Code, Republic Act 386 (Revised).

Philippines into a vibrant and expansive commercial economy of free and smoothly flowing capital and trade.[5] As Johnson J in *Torres v Limjap*,[6] rhetorically remarked, the aim of the Administration *"[was] to promote business and trade in these Islands and to give impetus to the economic development of the country [Philippines]."*

The nature and scope of existing security instruments of the Spanish civil law - namely, the pledge and *pacto de retro*[7] served only to frustrate the pursuit of that goal. The pledge, which required the collateral to be actually or constructively delivered to the creditor, deprived the debtor of the productive use of the property, thereby inhibiting the debtor's business enterprise[8] - a situation reminiscent of the credit and security constraint[9] in the US in the eighteenth century.[10] The *pacto de retro,* which was not accorded a full legitimate security status but was widely used as such for all practical purposes, subjected the debtor to the risk of the property being sold by the creditor even before the debtor defaulted. To mitigate this risk, US trained judges in the Philippines invoked the maxim *'equity looks at the substance and not form'*,[11] and treated the *pacto de retro* as an equitable mortgage

[5] *Torres v Limjap* (1931) 56 Phil 141, 146, per Johnson J.

[6] *Ibid.*

[7] "A contract of sale of movable property or immovable property with a right given to the vendor to repurchase the property"; see *Rosales v Reyes and Ordeveza* (1913) 25 Phil 495, 497, per Trent J. In early Roman civil law, it resembled the mortgage called 'fiducia'; see WL Burdick, Principles of Roman Law and Their Relation to Modern Law, WMW Gaunt & Sons Inc, Florida, p 379 (1989 Reprint). In contrast, in England, unless there was evidence of a security transaction, a conditional sale was an arrangement whereby ownership in the property was transferred from the vendor to the purchaser with a right given to the vendor to repurchase the property within a specified time; see *Perry v Meddowcroft* (1841) 4 Beav 201, 49 ER 315, and *Alderson v White* (1858) 3 Se G & J 95; 44 ER 924.

[8] See RL Jordan & WD Warren, *Commercial Law*, 4th ed, p 13, (1963).

[9] Until 1820, when the chattel mortgage was introduced by legislation, the only type of security that could be effected over personal property was the pledge; see Gilmore, Security Interests in Personal Property, Little, Brown and Company, Boston & Toronto (1965), s 2.1, pp24-25.

[10] The US attempted to solve the problem by introducing the chattel mortgage in the 19th century; see Gilmore, *ibid.*

[11] For a treatise on equity's jurisprudence in the US; see J Story, *Equity Jurisprudence*, Fred B Rothman & Co, Littleton, Colorado, 13th ed, Vol. II, s 1018, p 320, (1988, Reprint).

- a supplementary security device of common law heritage, unknown in the civil law. This had two immediate adverse ramifications for the creditor. First, it conferred upon the debtor the right to redeem the property, even though his right to recover the property had lapsed under the *pacto de retro* agreement, provided he could satisfy two demands of equity - namely, that the legal title was still with the creditor, and that he had repaid the creditor in full. This created uncertainty for the creditor because, until the property was sold, the debtor could redeem it at any time. Second, the equitable mortgage subjected the transaction to stringent rules against usury, which the creditor typically attempted to circumvent by means of the *pacto de retro*.[12] These factors contributed to the decline of the use of *pacto de retro* as a shrouded security instrument, particularly in the field of personal property.[13]

The equitable mortgage was subsequently given statutory recognition by Article 1602 of the post-independence Civil Code of 1948 (hereafter the 'New Civil Code'),[14] but this should not be regarded as the introduction of a new general consensual security instrument into the Philippines, nor as a wholesale import of equitable rules and

[12] See *Ramos v Court of Appeals* (1989) 180 SCRA 635, 649, where Regalado J stated that the main aim of treating the pacto de retro as an equitable mortgage was to prevent the circumvention of the laws against usury and the lender from appropriating the property.

[13] A review of the Philippines Law Report and the Supreme Court Reports Annotated in the last 100 years appears to suggest that the pacto de retro continues to be widely used to disguise domestic mortgages of real property (e.g. see *Adrid, et al. v Morga*, etc (1960) 108 Phil 927, and *Lazatin v Court of Appeals* (1992) 211 SCRA 129), but appear to be absent in security over personal property.

[14] Article 1602 presumed that a contract of sale was an equitable mortgage if it satisfied any of the following: (1) when the price of a sale with right to repurchase was unusually inadequate; (2) when the vendor remained in possession as lessee or otherwise; (3) when upon or after the expiration of the right to repurchase another instrument extending the period of redemption or granting a new period was executed; (4) when the purchaser retained for himself a part of the purchase price; (5) when the vendor bound himself to pay the taxes on the thing sold; and (6) in any other case where it may have been fairly inferred that the real intention of the parties was that the transaction should secure the payment of a debt or the performance of another obligation.

doctrines into the civilian system.[15] Thus, an equitable mortgage could still not be created deliberately and expressly in the Philippines, in the complex manner prevailing in common law jurisdictions.[16] The New Civil Code equitable mortgage is strictly regarded as a security implied by law, and the rights, obligations, and liabilities of the parties are strictly defined according to the security instruments of the pledge or the chattel mortgage,[17] as established by the substance of the transaction.[18]

In view of the above, in 1906, the US Philippines Commission[19] (hereafter 'the Commission') enacted the Chattel Mortgage Law Act,[20] which introduced into the Philippines a new credit security instrument - the chattel mortgage - for effecting non-possessory security over such property. This was substantially modelled on the chattel mortgage,

[15] In *Rosales v Reyes and Ordoveza* (1913) 25 Phil 495, Trent J observed that the pacto de retro was in substance similar to the chattel mortgage, but was not prepared to treat it as such for fear that he would be contradicting a fundamental civilian principle. However, in subsequent cases the courts treated the pacto de retro as an equitable mortgage; for example, see *Cyugan v Santos* (1916) 34 Phil 100 and *Macapinlac v Guitierrez Repide* (1922) 43 Phil 770. By the end of the US administration in the Philippines, the superimposition of the equitable mortgage on the pacto de retro had taken deep root and settled into domestic commercial law. When the New Civil Code was enacted in 1949 by the new Philippines legislature, Article 1602 gave statutory effect to the equitable mortgage. This provision regards a contract of sale as an equitable mortgage if the conditions contained in the Article are satisfied.

[16] For discussion of the various methods of creating equitable mortgages; see Fisher & Lightwood's *Law of Mortgages*, Butterworths, London, 10th ed, pp 1-5, (1988).

[17] This strict rule can be found in Article 2092 of the New Civil Code, which provides that: 'A promise to constitute a pledge or mortgage gives rise only to a personal action between the contracting parties...' In contrast, in a common law jurisdiction, this would have created an equitable security.

[18] See J Story, *Equity Jurisprudence*, Fred B Rothman & Co, Littleton, Colorado, 13th ed, Vol. II, s 1018, p 320, (1988, Reprint).

[19] A legislative body established by the US Administration; it was dismantled in 1907.

[20] It entered into force on 2 July 1906.

which was then in use in some states in the US.[21] The immediate commercial advantage of the chattel mortgage over the Spanish pledge is undeniable and best illustrated in *Torres*. In *Torres*, the owner of a drug store had mortgaged all the goods in his store to a lender to secure a loan granted by the lender. The mortgage agreement authorized the owner to sell the goods and to replace them with other goods thereafter acquired by the owner. When the owner defaulted in the repayment of the loan, the lender took possession of the goods for the purpose of disposing of them by public auction. The owner claimed that the lender's action was unlawful on the ground that the mortgage was invalid, because its extension to after-acquired property rendered the description of the property uncertain and therefore contravened the last paragraph of s 7 of the Chattel Mortgage Law Act. The paragraph provided that a chattel mortgage was deemed to cover only the property described in the mortgage and not to cover substituted property thereafter acquired by the mortgagor, anything in the mortgage to the contrary notwithstanding. Johnson J held that the mortgage did not contravene the paragraph and was therefore valid and binding on the owner. Accordingly, the action of the lender was lawful. Johnson J took the view that if a chattel mortgage were restricted only to existing property, the consequences would frustrate business activity in the Philippines, particularly in the retail field, where goods are constantly being sold and replaced by new stock. As Johnson J observed:[22]

> *'If said* [restriction] *were intended to apply to this class of business, it would be practically impossible to constitute a mortgage on such stores without closing them, contrary to the very*

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[21] Namely, North Dakota, California, Illinois and Oklahoma; see L Jones, The Law of Chattel Mortgage and Conditional Sales, The Bobbs Merril Company Publishers, Indianapolis, 6th ed, pp 1-4, (1908) where the author stated that the chattel mortgage at the end of the 19th century in the United States was "a conditional sale of chattels, and operates to transfer the legal title to the mortgagee, to be defeated only by full performance of the condition". Note, the Commission appears to have been ignorant of the fact that the chattel mortgage had become increasingly inefficient in the United States and was on the brink of being consigned to oblivion at the material time; see L Jones, *The Law of Chattel Mortgage and Conditional Sales*, Bobbs Merril Company Publishers, Indianapolis, 6th ed, pp 1-4, (1908).

[22] *Ibid*, p 145.

> *spirit and purpose of the said Act. Such a construction would bring about a handicap to trade and business, would restrain the circulation of capital, and would defeat the purpose for which the law was enacted, to wit, the promotion of business and the economic development of the country.'*

The chattel mortgage thus operates like the 'floating lien' in the US, a security which 'floats' over all the debtor's present and future assets.[23]

Another security device of US common law, introduced later by the courts, albeit less rhetorically - but presumably also in response to the new commercial needs of the Philippines ¾ is the trust receipt.[24] This is a special security device designed to facilitate short-term commercial bank lending,[25] again a concept unknown in the civilian system.

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[23] The chattel mortgage is similar to the 'floating lien' in the US, where the mortgagor is permitted to sell the secured goods in the ordinary course of his business and substitute the secured goods; see Gilmore, supra note 9, particularly s 11.7. The US does not have the 'floating charge', a corporate security instrument peculiar to common law jurisdictions. It permits the debtor to deal with its assets until the floating charge is converted into a fixed charge. Some of the major problems with the floating charge are: the difficulty of ascertaining when a charge is a floating charge or fixed charge; and the wide circumstances under which a floating charge may be converted into a fixed charge on crystallisation. Note, in New Zealand the Personal Property Security Act 1999 has abolished the floating charge.

[24] See Gilmore, *supra* note 9, ss 4.1 to 4.2. 2.1. The doctrine of trust receipt took form in the last quarter of the 18th century in the area of commercial banking to enable the banker's customer-debtor to dispose of the secured goods according to the strict instructions of the banker; *ibid*, s 4.2, pp 89-90.

[25] The trust receipt is the last stage in the chain of the process of granting security over goods to secure the same advances granted by the bank to the debtor to finance the purchase of goods from overseas. It is used when the debtor has to sell the goods in order to repay the advances. It is, therefore, a security device that is designed to give the bank a security interest of relatively short duration; see DK Malcolm, 'Uniform Commercial Code As Enacted in Massachusetts', (1958) 13 *Bus. Law* 490, pp 502-506, referred to by JW Wyatt & MB Wyatt, *Business Law-Principles and Cases*, Graw-Hill Book Company, New York, 6th ed, in Chapter 3, p 17,(1963).

The trust receipt was not given statutory effect until 1972 when the Trust Receipt Decree was promulgated.[26]

Today, the pledge, chattel mortgage and the trust receipt, legacies of Spanish civil law and the US common law are the only three forms of traditional consensual security that can exist in the Philippines.[27] Since the early 1970s, it has been argued that these security devices and their rules might be outdated,[28] but to date the Philippines Government has not conducted any comprehensive review of the credit security laws.

Against this background, the objective of this paper is to consider whether or not there is a case today to reform the law governing security over personal property in the Philippines[29] and if so, which model the Philippines should consider for reform of its existing structure. To this end, the baseline criteria of the Asian Development Bank (hereafter 'ADB') are adopted so as to evaluate the performance of the credit security legal framework of the Philippines in four key respects, namely, the creation, perfection, publicity, and enforcement of the pledge, chattel mortgage, and trust receipt. The baseline criteria of the ADB are:

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[26] The Decree was modelled on the then US Trust Receipts Act 1933. In the US, the trust receipt was given statutory effect in 1933 by the Uniform Trust Receipts Act 1933. The Act has been repealed and superseded by Article 9 of the US Uniform Commercial Code (Revised).

[27] In the Philippines, three non-traditional security instruments are also used to secure goods supplied on credit namely, lease with option to purchase, finance leasing, and conditional sale. They are outside the ambit of this article.

[28] See DE Allan, Mary E Hiscock, D Roebuck, *Credit and Security - The Legal Problems of Development Financing*, University of Queensland Press, St Lucia, Crane Russak & Company Inc., New York, pp 31-40 (1974).

[29] Note that this paper focuses on non-consumer credit security over personal property.

- the creation[30] and perfection[31] of secured transactions must be inexpensive, simple and comprehensive;
- there must be publicity of security transactions and the publicity must be inexpensive to file and easy to search; [32]
- the priority of secured transactions must be based on simple and unambiguous rules;
- the enforcement[33] of secured transactions must be fast and inexpensive; and[34]

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[30] 'Creation' is a "process by which the secured creditor and the debtor create the security interest and thereby confer on the secured party special rights, such as rights of enforcement of the collateral vis-à-vis the debtor"; see DV Davidson, BE Knowles & LM Forsythe, *Business Law*, West Educational Publishing Company, New York, 6th ed, p 659, (1998).

[31] 'Perfection' is the "process by which the secured creditor protects its security from the claim of subsequent creditors, secured or general"; Ibid, p 659. The process usually requires the security to be registered with the relevant authority. Failure to do so typically renders the security ineffective against the other creditors of the debtor.

[32] 'Publicity' is the means by which the security interest of the creditor is made known to the public; see *Law and Policy Reform at the Asian Development Bank*, Asia Development Bank, Manila, 2000 ed, Vol. II, and Part VII, p 56.

[33] 'Enforcement' relates to the 'rights' of the secured creditor to enforce the security; see DV Davidson, BE Knowles & LM Forsythe, *Business Law*, West Educational Publishing Company, New York, 6th ed, p 652, (1998). It deals with the types of remedies which the creditor is entitled to exercise in respect of the secured property if the debtor defaults in payment; see J Ziegel, 'Canadian Perspectives on the New Zealand Chattel Securities Act', (2001) 7 New Zealand Business Law Review 118, pp 123-124; and see also Article 9-601 of the US Uniform Commercial Code entitled, 'Default and Enforcement of Security Interest', which specifies the remedies of foreclosure, possession and sale of the secured property. See also RM Goode, *Legal Problems of Credit and Security*, Sweet & Maxwell, 2nd ed, pp 76-77, (1988), where the author discusses enforcement in the context of remedies.

[34] See Law and Policy reform at the Asian Development Bank, Vol. II, p 19, (2000 ed.). These baseline criteria were developed by the ADB to evaluate the efficiency of the credit security legal framework of five Asian countries, namely the People's Republic of China, India, Indonesia, Pakistan and Thailand. Note, for more expansive criteria, see DE Allan, *Securities Over Personal Property*, Butterworths, Sydney, Chapter 1, pp 4-5, (1999).

- the rules governing creation, perfection, publicity, and enforcement must be accessible and readily understandable to all creditors, debtors, and the general public.

In the first section of this paper, we examine the rules governing the creation of the chattel mortgage, pledge, and the trust receipt, in particular the formality and technicality surrounding the creation of the chattel mortgage and pledge. Second, we examine the external and internal rules governing the perfection of these security instruments. This is followed by an examination of the external and internal rules governing the publicity of these security instruments and consideration of the operational weaknesses of the publicity infrastructure that threaten to compromise the interests of third parties who might deal with the debtor. Fourth, we critically appraise the rules governing their enforcement. We conclude our discussion with some suggestions for reform of the present credit security legal framework governing security over personal property.

II. Creation

Section 3 of the Chattel Mortgage Law Act defines a chattel mortgage as a '*conditional sale of personal property for the payment of a debt, or in the performance of some other obligation specified therein; and the sale becomes void upon the seller (debtor) paying to the purchaser (creditor) a sum of money or doing some other act. If the condition is performed according to its terms the mortgage and sale immediately become void, and the mortgagee is thereby divested of his title*'. Unfortunately, this definition fosters material ambiguity. *Inter alia*, it is unclear whether the chattel mortgage constitutes a sale or a mortgage *strictu sensu* in common law terms? If deemed a sale, it is arguable that the Commission has resurrected, presumably unconsciously, the civilian *pacto de retro*, which, as discussed earlier, had previously fallen into desuetude.[35] If the latter interpretation is to be preferred, which, it is submitted, is the better view,[36] s 3 can be viewed as importing into the Philippines a common

[35] *Supra* note 13.

[36] See case of *Serra v Rodriguezit* (1974) 56 SCRA 538.

law concept[37] unknown in the civilian system. It is thus rather surprising that judicial criticism of the definition did come until a decade later in *Bachrach Motor Co v Summers*,[38] where Street J, a US trained judge, commented:[39]

> 'The use of the term conditional sale in connection with the chattel mortgage is apt to be misleading to a person unacquainted with the common law history of the contract of mortgage; and it is unfortunate that such an expression should have been incorporated in a statute intended to operate in the Philippines...the idea is totally foreign to the conception of the mortgage which is entertained by the civil law...The author of section 3 of the Chattel Mortgage Law was most unhappy in his effort to elucidate to civilian jurists the American conception of the contract of mortgage.'

Legislative correction of the jurisprudential error was even slower. Rectification was not attempted for some forty years and ultimately took the form of Article 2140 of the New Civil Code. This provided that: 'By a chattel mortgage, personal property is recorded in the Chattel Mortgage register as security for the performance of an obligation.' Subsequently, the courts were emphatic in finding that the terms had effectively remedied the flaw of s 3. It was held that a chattel mortgage is a security and not a 'conditional sale.'[40] It is submitted that this decision lacks substance - it is no more than a superficial attempt to resolve earlier confusion on the nature of the instrument purportedly created by s 3. Strictly, except for the word 'security', the terms of this Article have not explicitly added anything

[37] In England (the home of the common law) the 'legal mortgage' itself was criticised by both academics and the courts. For example, Maitland described the common legal mortgage as a sham and the mortgage deed as being suppressio veri and suggestio falsi; see Maitland, Equity, Cambridge University Press, Cambridge, 1st ed, p 269 (1929, Reprint); and *Samuel v Jarrah Timber and Wood Paving Corporation, Limited* [1904] AC 232, 326, where Lord Macnaghten states: "...no one, I am sure, by the light of nature ever understood an English mortgage..."

[38] (1921) 42 Phil 3.

[39] See *Bachrach Motor Co v Summers* (1921) 42 Phil 3, at 8-9; see also *Serra v Rodriguez* (1974) 56 SCRA 538.

[40] See *Serra v Rodriguez, ibid.*

which might suggest, in theory or practice, that the transaction envisaged by s 3 was not a security. Further, it has not resolved the second proposition of a common law legal mortgage. One would have thought that the appropriate step would be to repeal s 3 and replace it with an unambiguous definition of a chattel mortgage in terms consistent with the civilian charge or *hypothecation*. Unfortunately, creative judicial interpretation, however emphatic, simply condones legislative indifference - it does not erase the juridical flaw of the chattel mortgage from the statute book of the Philippines.

That said, the rules governing the creation of the chattel mortgage law are theoretically simple. Any person can create a chattel mortgage in favour of any other person to secure any personal property, tangible and intangible, both present and after-acquired;[41] a single set of rules of creation apply to both corporate and non-corporate borrowers; and a single security terminology with distinct effect and consequences is consistently used to create non-possessory security in all security transactions. The latter characteristics lend the chattel mortgage a gloss of modernity and promote a straightforward approach in effecting security over personal property, particularly when they are contrasted with the common law non-possessory security, which is notorious for its cumbersome process of creation, verbose security terminologies,[42] and discrimination between corporate and non-corporate borrowers.[43]

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[41] This extension to after-acquired personal property must however be expressly agreed by the parties; see s 7, para 5, Chattel Mortgage Law Act.

[42] There are no less than eight security devices with different names, namely, the legal mortgage strictu sensu, the equitable mortgage strictu sensu, the equitable fixed charge, equitable floating charge, hypothecation, trust receipt, contractual lien, and pledge.

[43] For example, the creation process of corporate security is governed by the general law and the companies legislation: for Hong Kong, see the Companies Ordinance (Cap. 32), for Malaysia, see the Companies Act 1965 (A.125, Revised 1973); and for Singapore, see the Companies Act (Cap.185). In the case of non-corporate borrowers, the creation of non-possessory security is governed by the bills of sale legislation; for Hong Kong, see the Bills of Sale Ordinance (Cap.20), for Malaysia, see the Bills of Sale Act 1950 (Revised 1982); and for Singapore see the Bills of Sale Act (Cap 24) 1985 Ed.

The chattel mortgage thus avoids certain complexities and anomalies prevalent in common law jurisdictions.[44]

However, when the creation rules are examined, it is arguable that theoretical simplicity is subsumed by operational archaism in the form of pedantic documentary formality.[45] To create a valid and effective chattel mortgage against third parties the creditor must ensure that the chattel mortgage document contains certain specified information. This includes: the date of the chattel mortgage; the names and addresses of the mortgagor and mortgagee; an express conveyance of the personal property to the mortgagee; a description of the personal property and where it is situated; the sum of money secured by the mortgage; the rate of interest per annum; a statement that the mortgage becomes null and void when the obligations of the mortgage are fully performed; signatures of the mortgagor and two witnesses.[46] Additionally, the creditor must ensure that the chattel mortgage is accompanied by an affidavit of good faith duly executed by the mortgagor and mortgagee in the presence of a notary public. The affidavit must state, in the prescribed form, that the mortgagor swears that *'the foregoing mortgage is made for the purpose of securing the obligation specified in the conditions thereof, and for no other purpose, and that the same is a just and valid obligation, and one not entered into for the purpose of fraud'*. If the chattel mortgage does not contain the affidavit in the proper form, the security is not enforceable against the mortgagor or third parties.[47] Whilst it is admitted that some of the prescribed information would prove useful to subsequent third parties

[44] These complexities and anomalies arose from the multiplicity of security devices with different terminologies and consequences. This problem is now resolved in the US. Under Article 9 of the UCC (Revised), only a single security device is permitted to subsist; see D V Davidson, B E Knowles, & LM Forsythe, *Business Law*, West Educational Publishing Company, United States, pp 647-650, 6th ed, (1998).

[45] This was inherited from 18th century practice in the US; see Gilmore, *supra* note 9, p 52.

[46] Section 5 of the Chattel Mortgage Law Act.

[47] See *Giberson v Jureidini Bros* (1923-24) 44 Phil. 217, where the court held that a chattel mortgage granted by a partnership was invalid on the grounds that the registered chattel mortgage did not sufficiently describe the goods or contain an affidavit of good faith.

who might deal with the debtor, it is questionable whether the affidavit of good faith serves any significant purpose. Gilmore, with reference to the old US chattel mortgage, observed:

> 'How well these formal devices served as deterrents to fraud must be a matter of opinion. It is not inconceivable that a lender, intent on defrauding his borrower, may have been deterred by being required to have his signature witnessed with solemn legal pomp and by being additionally required to swear that he had given consideration and was acting in good faith. On the other hand, it is hard to escape the conclusion that most of the cases in which mortgages were set aside for one or another type of technical compliance involved entirely legitimate and good faith transactions; the cases were brought, not by the presumably defrauded mortgagor, but by his creditors (or their representatives) who had not in any sense been damaged or misled by the formal defect.'[48]

Gilmore's observation also rings true, in some cases, in the Philippines. In *Giberson*, a chattel mortgage granted by a partnership was held to be void against subsequent creditors because it did not contain an affidavit of good faith, although the mortgagee-creditor was clearly not guilty of any fraud.[49] This danger to creditors should not, however, be overstated. Today, it is rare to find a chattel mortgage without such an affidavit. Nonetheless, its retention is at odds with modern credit security documentation. For example, in the US, Article 9 of the Uniform Commercial Code (revised) ('UCC') has done away with signature formalities and accompanying affidavits. It is true that, in some developed economies in the Asian Region,[50] there is legislation, such as the Bills of Sale Act and Bills of Sale Ordinance,[51] that stipulates the observance of certain formality in connection with subscription, but

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[48] *Supra* note 9, Gilmore, see s 2.7, p 52.

[49] *Giberson v Jureidini Bros*, cited above at 47, at 217.

[50] For example, Hong Kong, Malaysia, Singapore and some Australian states.

[51] *Supra* note 42.

these are colonial legacies of the nineteenth century, and even in those cases there are calls for reform today.[52]

However, the Chattel Mortgage Law Act displays a good degree of tolerance and flexibility towards other special information discussed earlier. Section 5 of the Act provides that a chattel mortgage is deemed sufficient if it is substantially in conformity with the chattel mortgage statutory form. This generous criterion is often regarded as having been satisfied if the words used '*enable the parties in the mortgage or any other person, after reasonable inquiry and investigation to identify*'[53] the property affected by the mortgage. Whilst it is arguable that this flexibility is justifiable on the ground that subsequent creditors should not be allowed to take advantage of a mere default in technicalities, certain valid criticisms can be levelled.[54] First, this policy violates the objective of a registration system, namely that searches at the registry must be final. Any subsequent creditor wishing to deal with the debtor has to take additional steps to verify with the earlier creditor each and every item of personal property, to ascertain whether or not they are subject to the earlier mortgage. However, the words used in the chattel mortgage document may not necessary warn the subsequent creditor of the need to take this precaution. For instance in *Strochecker v Ramirez*,[55] a subsequent mortgagee failed to make inquiries with the prior mortgagee on certain specific goods in a medical drug store affected by the earlier mortgage because the general words used in the earlier mortgage seemed to suggest that the affected goods were not covered by the earlier mortgage. When the debtor became insolvent, the court held that the earlier chattel mortgagee was

[52] See the English Law Commission Paper No.164, Registration of Security Interests: Company Charges and Property Other Than Land, (July 2000) and the Australian Law Reform Commission report No. 64, Personal Property Securities, (1963) para 1.9, and see also the New Zealand Personal Property Security Act (1999) which abolished the Bills of Sale Act and adopted the notice-filing system of Article 9 of the US Uniform Commercial Code.

[53] *Saldana v Phil Guaranty Co* (1960) 106 Phil 919, 912, per Reyes J.

[54] A common theme in the common law jurisprudence, for example; see Harman J in *Rhodes v Allied Dunbar Pension Services* [1987] 1 WLR 1703, 1708, the prohibition was intended to prevent people exploiting the technical failure to serve notice on the fundholder.

[55] (1922-23) 44 Phil 993.

entitled to the goods in priority to the subsequent mortgagee because the general words sufficiently secured the goods. Second, such flexibility does not encourage the creditors to be diligent. It could be argued that the earlier creditor, should be motivated to protect his financial interests effectively and thus that he bears the burden to be succinctly clear on the collateral he has obtained as security.

As is the case with the security instruments of Article 9 of the UCC and the common law jurisdictions, the chattel mortgage is endowed with two distinct flexibilities. It can secure after-acquired personal property of the debtor, provided such is expressly agreed between the parties,[56] and the secured property can be substituted by other property during the term of the chattel mortgage. That said, the ability to secure after-acquired property does pose some problems for subsequent third parties who wish to deal with the debtor.[57]

It should be noted that the chattel mortgage cannot be extended to secure any subsequent advances to the debtor by the same creditor. As the words of the statutory affidavit clarify: *'the chattel mortgage is made for the purpose of securing the obligation specified therein and for no other purpose'*. In *Belgian Catholic Missionaries v Magallanes Press*,[58] the court held that these words restricted the mortgage to existing credit facilities only, any express agreement in the mortgage to alter the statutory limitation being invalid. Consequently, any subsequent increase in credit is unsecured.[59]

This limitation nonetheless bestows two advantages. First, it avoids the complicated issues of competing intervening claims, such as security over the same property granted to a third party before new credits are granted to the debtor under the first security. Second, there is an improvement in transparency and certainty. A subsequent third party who deals with the debtor is certain of the amount owing by the debtor and secured by the asset. However, this restriction is not reflected by

[56] This may pose some problems for subsequent third parties wishing to deal with the debtor. For discussion, see section III below.

[57] For further discussion of this point, see section III below.

[58] (1926-27) 49 Phil 647.

[59] In *Jaca v Davao Lumber Company* (1982) 112 SCRA 107, the court held that a chattel mortgage to secure future advances was invalid.

the security instruments of Article 9 of the UCC[60] or at common law.[61] The extension of the security is founded on the common law doctrine of 'tacking further advances', which is a highly complex legal field. There is debate in common law jurisdictions as to whether this doctrine should be retained. It is submitted that the majority view is that it should be preserved because it reduces the cost of borrowing,[62] and any potential prejudice to an intervening third party's advances can be avoided by requiring the creditor to file with the appropriate register a notice warning of the creditor's right to tack further advances. In light of the Philippines' system of taxing and charging the registration of chattel mortgages on an *ad volerem* basis, there is a case for review of the chattel mortgage restriction.

The pledge is commonly used in the Philippines to secure goods for commercial lending. It shares the same substantive features as its US equivalent. The first, in the case of tangible personal property, is that possession of the goods must be actually or constructively delivered to the pledgor.[63] The second, in the case of intangible property, is that the document of title or evidencing title in the intangible property must be delivered to the pledgee. This rule is derived from a principle applied in the US in the early nineteenth century,[64] which differed from the strict English common law rule that intangible property, except negotiable instruments, could be pledged. Note however that adoption of this rule did not introduce a novel concept into the Philippines. Rather it extended an already existing rule under Article 1872 of the old Spanish Civil Code,[65] which limited pledges to shares of corporation to other forms of intangible property, such as negotiable instruments,

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[60] See s 204 (c).

[61] For discussion of this doctrine in common law jurisdictions, see EI Sykes & S Walker, *The Law of Securities*, The Law Book Company Limited, Sydney, 5th ed, and pp 393-394, (1993).

[62] This is based on the assumption that debtor does not have to create a second mortgage over the same property, thereby saving lawyer's fees and tax.

[63] *El Banco Espabol-Filipino v Peterson* (1907) 7 Phil 204.

[64] *Supra* note 9, Gilmore, pp 5-23.

[65] See FC Fisher, *The Civil Code of Spain With Philippines Notes and References*, The Lawyer's Co-operative Publishing Co., Manila, Philippines & Rochester, New York, p 384, (1918).

receivables, debts, and credit balances, where ownership is comprised in a document of title or evidenced by some other document, such as a negotiable instrument.[66] One distinct difference in the Philippines' version is that the pledgee is required to execute a formal pledge document, which describes the subject of the pledge and the date of the pledge, and must be executed by the parties in the presence of a notary public. The aim of this formality, as in the case of the chattel mortgage, is to prevent fraud. A pledge that fails to comply with these requirements is unenforceable against the claims of a subsequent creditor.

One interesting feature of the practical operation of the statutory pledge lies in relation to security effected over shares of corporation. The standard pledge documents[67] usually contain, *inter alia*, the following pertinent terms: (a) the pledgee, in all applicable cases, may at his discretion, have the pledge registered at any time on the books of the issuing corporation, or have all or any portion of the securities transferred to his name or to the name of his nominee;[68] (b) in the event that the pledgor fails to pay any portion of the indebtedness hereby secured... the pledgee or his representative as the true and lawful attorney-in-fact of the pledgor, with full power and authority, is entitled to sell any part of the shares pledged... and any such sale may be made either at public or private sale...or in any brokers' board or securities exchange and the pledgee may, in all allowable cases, be the purchaser of any of the shares so sold...;[69] (c) The pledgee may, at its option, collect, by legal proceedings or otherwise, endorse and receive all dividends.[70]

These terms raise some serious questions of efficacy and legality. First, the expression in (b) casts doubt on the validity and effectiveness of the pledgee's power of sale.[71] Second, in pursuance of a right under

[66] See Article 2095 of the New Civil Code.

[67] The standard document can be found in 'Form No.49A: Pledge Agreement' of S Guevara, Legal Forms Annotated, Rex Book Store, Manila, 15th ed, 1997, p 117.

[68] *Ibid*, at p 119, paragraph 3.

[69] *Ibid*, at p 119-120, paragraph 4.

[70] *Ibid*, at p 119, paragraph 3.

[71] This is discussed further in section IV below.

term (a), pledgees in the Philippines usually register the shares in their names with the register of the issuing corporation.[72] However, insofar as third parties are concerned, this offers little advantage. As in the US and other common law jurisdictions, the registration does not impose constructive notice of the pledge on third parties dealing with the pledgor of the shares, nor does it perfect a pledge that is otherwise invalid.[73] Third, the second part of the expression in (a), i.e. the pledgee is *entitled to have the shares transferred to its name or its nominee,* appears to import the common law legal mortgage *strictu sensu* - a concept, as hitherto discussed, unknown in the civilian system. Early cases affirmed the civilian rule. For instance, in *Martinez v Philippine National Bank*[74] and *PNB v Atenido,*[75] (although not involving shares), the Supreme Court held that in a pledge, ownership in property remained with the pledgor.[76] However, in the more recent case of *Lopez v Court of Appeal,*[77] the court found the term to be valid. In *Lopez*, a borrower executed a deed which stated that in consideration of the guarantor guaranteeing a loan granted by the bank to the borrower, the borrower 'sells, assigns and transfers' 4,000 shares in a corporation to the guarantor. In pursuance of the deed, the borrower deposited the share certificates and the duly executed transfer forms with the guarantor. The Supreme Court held that the transaction created a pledge and that the shareholder was entitled to have the shares registered in his name. In reaching this decision, the court relied on the

[72] For example, see *China Banking Corporation v Court of Appeals* (1997) 270 SCRA 503, and also *Lim Tay v Court of Appeal* (1998) 293 SCRA 634. In both cases the pledgee registered the pledge in the register book of the issuing company.

[73] *Monserrat v Ceron* (1933) 58 Phil 469; and *Chua Guan v Samahang Magasaka* (1935) 62 Phil 477. These cases were concerned with chattel mortgages of shares. The chattel mortgage was held to be null and void for default in registration with the Register of Deeds. Registration with the issuing corporation did not validate the chattel mortgages.

[74] (1953) 93 Phil 765.

[75] (1954) 94 Phil 254.

[76] Article 2140 of the New Civil Code clearly states that a pledge is merely a delivery of possession of the property. See Monserrat v Ceron, supra note 69, the court held that a pledge of shares did not constitute a 'transfer of ownership'.

[77] (1982) 114 SCRA 671.

American Jurisprudence postulation that *'...[the pledgee] may have the shares transferred to him on the books of the corporation if he has been authorised to do so'* as authoritative.[78] It is arguable that *Lopez* is clearly unsatisfactory for the following reasons. First, it is inconsistent with *Martinez v Philippine National Bank* and *PNB v Atenido*, which, as discussed earlier, held that in a pledge the legal ownership always remained with the pledgor.[79] More importantly, it also conflicts with Article 2140 of the New Civil Code, which clearly states that a pledge is merely a delivery of possession of the property without transfer of ownership.[80]

One attraction of the statutory pledge is that it avoids an artificial distinction[81] in the common law credit security jurisprudence ¾ a distinction between the treatment of the negotiable instrument, which constitutes a pledgeable form of intangible property owing to its physical manifestation, and other species of intangible personal property that are strictly not pledgeable. However, it appears this may be another motive underlying the statutory pledge exception - namely, to resolve some of the problems generated by the chattel mortgage in relation to security over shares of corporation (see below). There is further anomaly between the statutory pledge and the chattel mortgage in that the

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[78] American Jurisprudence - 'Secured Transaction', 2nd, Vol. 68, s 62,

[79] This is also consistent with the common law where the interest of the pledgee in the property is described as 'special property' as opposed to 'general ownership': see *Donald v Suckling* (1866) LR I QBD 585, and *The Odessa* (1916) I AC 145.

[80] See also Gilmore, *supra* note 9, s 1.1, p 8, where the author states, "...the mortgagee got title or an estate whereas the pledgee got merely possession with a right to foreclosure on default."

[81] For criticism of this point, see *Paget's Law of Banking*, Butterworths, London, 12th ed, 2002, by M Hapgood, para 31.18. This exception was not common law in origin, but a rule of the law merchant, which was absorbed by the common law in the 16th century: see Walker & Walker, *The English Legal System*, Butterworths, London, 5th ed, by RJ Walker, pp 67-68, (1985). This exception has been criticised as creating an artificial distinction in the sphere of intangible personal property, i.e. a chose in action (intangible property) is given the physical attributes of goods (tangible property) which it does not possess: see *Paget's Law of Banking*, para 31.18.

statutory pledge can secure future advances because there is no provision in the New Civil Code that prohibits this.[82]

Generally speaking the trust receipt in the Philippines[83] resembles the trust receipt in the US and other common law jurisdictions, both in form and substance. The Trust Receipt Decree clearly defines the relationship between creditor and debtor. The creditor under the trust receipt is called the entruster and the debtor, the person who has possession of the goods,[84] is called the entrustee.[85] To avoid any doubt or suggestion that the instrument creates a trustee and beneficiary relationship as understood in equity's jurisprudence, the Decree expressly provides that the trust receipt is a security that creates a 'security interest' in the goods offered as security.[86] Attempts to redefine this with an investor and investee relationship, so that the entrustee-debtor is not liable to the entruster-creditor, in the event that there is any deficiency after the sale of the goods by the entrustee, was quickly rejected by the courts as being contradictory to the terms of the Decree.[87]

In practice, trust receipts of commercial banks replicate the terms of the Decree. The trust receipt is, therefore, easy to create, cost effective and is not subject to the aforementioned formalities of the chattel mortgage and pledge.

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[82] Indeed, under the old Spanish Civil Code, Article 1866, permitted the pledge to secure future advances. However, note that the permissible part of this Article was omitted from the recast Article 2098 of the New Civil Code.

[83] See S Guevara, Legal Forms Annotated, Rex Book Store Inc., Manila, 15th ed., pp 117-123 (1998), for Form No.75, 'Trust Receipt'.

[84] Section 3(a) Presidential Decree 115, 1972.

[85] See A Agbayani, *Commentaries and Jurisprudence on the Commercial Laws of the Philippines*, AFA Publications Inc, Manila, 1991, Vol.2, at p 409.

[86] Section 3(h), applied in *Samo v People* (1962) 5 SCRA 354 and *Vintola v IBAA* (1987) 150 SCRA 578.

[87] See *Vintola v IBAA* (1988) 159 SCRA 140; following earlier cases of *Samo v People* (1962) 5 SCRA 354, and *Siva v People* (1983) 121 SCRA 655.

III. Perfection

The rules governing perfection of the chattel mortgage, pledge, and trust receipt can be classified as either rules of internal or external perfection. The internal perfection rules are linked to the rules of creation, such as the requirements of a valid contract and formalities, if any. When these are complied with, the security is generally valid and enforceable against both the debtor and third party, who might subsequently have acquired an interest in the same property. External rules are special regulations relating to the registration of the security. The security instrument must comply with these requirements to ensure that the security can be made binding, particularly on the third party. In the Philippines, the external perfection rules are creatures of legislation and their objective is to publicize the security so as to protect third parties against the potential fraud of the debtor.

With regard to the chattel mortgage, s 4 of the Chattel Mortgage Law Act requires the creditor to register the chattel mortgage with the Register of Deeds. To encourage compliance, the Act penalizes the defaulting creditor by rendering the chattel mortgage invalid and unenforceable against third parties dealing with the debtor in respect of the property.[88] Other operative features of the registration system are discussed below.

First, to effect registration, the creditor must deliver all the necessary documents specified by the Chattel Mortgage Law Act to the Registrar of Deeds.[89] The Registrar must record in the registration book all relevant particulars of the chattel mortgage and the precise time of registration.[90]

Second, the system of double registration requires certain chattel mortgages to be registered with the Registrar of Deeds of different provinces.[91] This system applies in two situations. The first is when the secured movable property is situated in a province that is different

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[88] Section 4 Chattel Mortgage Law Act.

[89] *Ibid.*

[90] Section 115 Presidential Decree No.1529 (1972).

[91] *Supra* note 88.

from the province where the mortgagee resides. In this case, the chattel mortgage must be registered at the Register of Deeds of both provinces. The second is when the secured assets comprise shares of a corporation. Here, if the corporation's registered office or principal place of business is situated in a province different from the province where the mortgagor resides, double registration is, again, required.[92] The double registration requirement has been criticised as cumbersome and cost inefficient given that it unnecessarily compels potential creditors to search the records of every province in which a mortgage granted by the debtor might be registered.[93]

Third, the Act does not specify the period during which a chattel mortgage must be registered with the Registrar of Deeds. This, at first sight, appears to encourage laxity and potentially weakens the efficiency of the registration system. However, this is avoided in practice, because the courts have consistently held that the date of registration determines the priority of competing claims over the same secured asset. Thus it is always advisable for the creditor to register the mortgage as quickly as possible. In this respect, the registration system of the Philippines is arguably superior to its counterparts in some of the common law jurisdictions of the Asian Region,[94] where complex issues, such as whether the security interests are legal or equitable, may cloud the question of priority of competing interests, even though the security may be duly registered.[95] Finally, the registration of a chattel mortgage imposes constructive notice of the mortgage on the whole world,[96] except subsequent purchasers who acquire the goods in the ordinary course of the debtor's business.[97]

[92] *Malonzo v Luneta Motor* (1956) 52 OG 125566; and also *Fua Chun v Summers and China Banking Corporation* (1923) 44 Phil 705.

[93] See *Chuan Guan v Samahang Magasaka* (1935) 62 Phil 477, 478-481, per Buttel.

[94] For example, Hong Kong, Malaysia and Singapore.

[95] Today, the trend is towards adopting the date of registration of security instruments as the general rule for determining priority, see Article 9 of the Uniform Commercial Code, New Zealand Personal Property Security Act 1999, and see also the notice-filing system proposed by the English Law Commission Paper No.164, Registration of Security Interests: Company Charges and Property Other Than Land, (July 2000).

[96] *Sison and Sison v Yap Tico and Avancena* (1918) 37 Phil, at pp 592-593; and *Standard Oil Co of New York v Jaramillo* (1922-23) 44 Phil 630, at p 632.

[97] See *Torres v Limjap, supra* note 5.

There is no separate mechanism, such as registration, for perfecting pledges in the Philippines in this context. It co-exists with the process of creation. A valid pledge, being a superior security interest, has priority over any subsequent encumbrances.

There are no special rules of perfection applicable to the trust receipt. Indeed, there is no particular formality with which a trust receipt must comply and the instrument is excluded from the registration system.

IV. Publicity

The chattel mortgage system is rendered publicly accessible by the inexpensive[98] and technically unrestricted search facility provided by the Register of Deeds. In theory, the search procedure is relatively straightforward. However, in practice, the double registration requirement, poor filing-system, and large number of chattel mortgage instruments filed each day, conspire to ensure that the search process is slow and cumbersome. Because of this, searches are very rarely made at busy Registers of Deeds[99] without detailed particulars of the security file number.[100] Owing to this lack of transparency, creditors who agree to take tangible personal property as security are exposed to the serious risk that the property may be encumbered by a prior security.

The Philippines have attempted to solve this problem by enacting Article 319 (2) of the Revised Penal Code, which makes it a criminal offence for any mortgagor to sell, pledge or further mortgage any mortgaged property without the written consent of the earlier mortgagee. On conviction, the mortgagor is liable to imprisonment or a fine

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[98] Currently it is P6.00.

[99] For example, the commercial centre of Manila.

[100] One of the authors of this paper visited the Register of Deeds at Manila. According to the author's personal observation and interview with the Deputy Registrar of the Register of Deeds of Manila, it is difficult to make a search without the registration particulars because of the thousands of chattel mortgages registered each year. The Deputy Registrar's comment was confirmed by another Attorney at RTC La Trinidad, 2601, Benguet, Philippines, in response to the author's inquiry.

amounting to twice the value of the property.[101] This may serve to discourage dishonest debtors from defrauding creditors, but it puts the Philippines' credit security laws at odds with mainstream credit security legal frameworks of other Western[102] and Asian economies,[103] which not only fail to criminalise such acts, but actually permit the debtor to create subsequent security. It is submitted that this may be justified on the ground that the debtor should not be subject to the absolute economic clutch of the creditor, who might not wish to lend the debtor further advances, yet it prohibits the debtor to borrow from a more willing creditor on the security of the same collateral, the value of which might be over and above the total outstanding loan.

There is no statutory publicity of the statutory pledge. The pledgee's possession of the goods or the documents evidencing title is deemed both to constitute sufficient publicity that the intangible property is encumbered and to negative any potential false representation of 'wealth' by the debtor-an inherent problem of non-possessory security devices.[104]

As in the case of the pledge, the trust receipt is not registrable with the Register of Deeds. There is therefore no requirement for formal publicity of the trust receipt. One reason is for this that the trust receipt is a short-term security instrument. The debtor is expected to dispose of the goods within a short time and repay the loan. Thus, it is argued that the creditor should not be unnecessarily inconvenienced by a cumbersome registration system. Moreover, uplike the chattel mortgage, it is the creditor-entrustor, not the subsequent third party, who is subject to a risk of losing his security. Section 11 of the Trust Receipt

[101] For example, in *People v Agoncillo* (1954) 50 OG No. 10 4884, the mortgagor was charged under Article 319, but acquitted on technical grounds, the first mortgage being invalid; but in *Dy Jr v Court of Appeal* (1991) 198 SCRA 826, a chattel mortgagor was convicted for selling the chattel mortgage without the written consent of the mortgagee.

[102] For example, the United States, the United Kingdom, Australia and New Zealand.

[103] For example, Hong Kong, Malaysia and Singapore.

[104] Many common law jurisdictions (such as the United Kingdom, Hong Kong, Malaysia, Singapore and Australia) attempt to solve this problem by enacting Bills of Sale legislation which require a variety of non-possessory security devices over personal chattels to be registered with designated authority. Unfortunately, the operational aspect of the legislation is often cumbersome and inefficient.

Decree stipulates that a subsequent *bona fide* purchaser for value takes the goods free from the security interest of the creditor. This rule is derived from a settled principle of the common law.[105]

Unfortunately, this lack of publicity has encouraged widespread fraud among debtors. As the court has observed, misuse or misappropriation of the goods or proceeds of sale is commonplace and this has created *'havoc in the trading and banking community'*.[106] To discourage fraud, the Philippines has, once again, resorted to adopting the drastic step of criminalising abuse or breach of the trust receipt. Section 13 of the Trust Receipt Decree specifically makes it a criminal offence, punishable with imprisonment, if the debtor fails either to account to the creditor for the proceeds of sale of the goods or to return the goods, if they are not sold, according to the terms of the trust receipt. This has not, however, completely prevented the debtor from abusing the confidence of the creditor.[107]

IV. Enforcement

Only the pledge and chattel mortgage afford the creditor propriety remedies in the event of default of the debtor. These comprise of taking possession and 'foreclosure' (i.e. sale)[108] of the secured personal property. The creditor under a trust receipt has only a personal action against the debtor if the debtor fails to account for the proceeds from the sale of the property.

Foreclosure, in the strict common law sense,[109] does not exist in the Philippines, because Article 2088 provides that the creditor cannot

[105] See *Lloyds Bank Ltd v Bank of America National Bank Trust & Savings Association* [1938] 2 KB 147.

[106] *People v Nitafan* (1992) 207 SCRA 726, referred to in *Metropolitan Bank and Trust Company v Tonda* (2000) 338 SCRA 254, at p 270.

[107] For example, see *Metropolitan Bank and Trust Company v Tonda* (1999) 318 SCRA, where the court convicted the customer for failure to account to the bank for the proceeds realised from the sale of apparels held under a trust receipt.

[108] In the Philippines, 'foreclosure' is actually a 'sale' by private treaty or by public auction.

[109] In the common law 'foreclosure' means the mortgagor's right to redeem the secured property after default is declared by the court to be extinguished and the mortgagee is left the absolute owner of the property.

appropriate the things given by way of pledge or mortgage. Any stipulation to the contrary is null and void. However, the New Civil Code, adopting a provision of the old Spanish Civil Code,[110] makes one narrow exception: the pledgee is allowed to appropriate the property if it remains unsold after being offered for sale at two duly constituted public auctions.

Taking Possession

The chattel mortgagee's right of possession is implied by the Chattel Mortgage Law Act.[111] In practice, the chattel mortgage agreement expressly confers such power on the creditor and it can be exercised without the aid of the court.[112] However, notwithstanding this, for two reasons Philippine creditors usually apply to the court for an order of possession.[113] First, often the debtors do not voluntarily deliver possession of the secured property to the creditor. Second, the creditor may aim to secure the more advantageous remedy of judicial sale.[114]

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[110] Article 1872 of the Spanish Civil Code provided, 'If the pledge should not be sold at the first auction a second one, with the same formalities, may be held; and should no result be attained the creditor may become the owner of the pledge'.

[111] See *Bachrach Motor Co v Summers* (1921) 42 Phil 3, pp 5-7, per Street J; and also *Luneta Motor Co v Dimagiba*, et al (1961) 113 Phil 865; and *Filipinas Investment & Finance Corp v Ridad* (1969) SCRA 565, where the mortgagees instituted replevin suits and were granted orders of possession.

[112] In *US Commercial Co v Halili* (1953) 93 Phil. 271, 274, Sanchez J stated: "... in the present case court action for such purpose was not essential because the contracts specifically authorized the lessor to repossess the vehicles whenever the lessee defaulted in the payment of rent..."

[113] The application of the creditor for possession must be inter partes. In Luna v Encarnacion (1952) 91 Phil 531, an order of possession granted by the lower court on an ex parte application was set aside by the Court of Appeal.

[114] For more detailed comment, see below.

Foreclosure (Sale)

The remedy of sale is a popular means of redress for the pledgee-creditor because he already has possession of the property.[115] In seeking to invoke the power, the pledgee-creditor must strictly observe the substantive and procedural provisions of the New Civil Code, which govern the exercise of the remedy. These provisions adopt and amplify the corresponding provision in the old Spanish Civil Code.[116]

First, with regard to the issue of substantive rights, according to Article 2087 of the New Civil Code, the pledgee-creditor's power of sale arises only after the debtor has failed to pay the debt when it falls due. Second, with reference to the procedural rules governing the actual exercise of the remedy, the pledgee-creditor must comply with Articles 2112 to 2116 of the New Civil Code. These can be summarized as follows:

- The pledgee-creditor must appoint a notary public to effect the sale.
- The sale must be conducted at a public auction.
- The debtor must be notified of the auction and the reserve price.
- If at the first auction the goods are not sold, a second auction with the same formalities must be held.
- The debtor may bid at the public auction. If the debtor offers the same price as the highest bidder, the debtor has a better right to the goods.
- The pledgee-creditor may also bid, but the offer is not valid if it is the only bidder.
- After the public auction the creditor must promptly advise the debtor of the result.

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[115] In the Philippines, the New Civil Code and the Pawnshop Regulation Act No. 144 govern the creditor's power of sale. However, given that it is essentially consumer protection oriented legislation, the Pawnshop Regulation Act is outside the ambit of this article.

[116] See Article 1872 of the Spanish Civil Code; source, FC Fisher, *The Civil Code of Spain - With Philippines Notes and References*, The Lawyer's Co-operative Publishing Co., Manila, Philippines & Rochester, New York, p 384, (1918).

At first sight these procedural rules may appear unnecessarily cumbersome. However, they can be justified on the grounds that they serve to protect the debtor against any fraud, collusion or misconduct on the part of the pledgee-creditor, auctioneer or purchaser.

Two features of the remedy of sale deserve the special attention of the pledgee-creditor. First, as aforementioned, the New Civil Code confers upon the pledgee-creditor the right to appropriate the secured asset if a second auction is held and the asset remains unsold. The pledgee-creditor must, however, be cautious because on appropriation the entire debt owing by the debtor is discharged. There is no right to sue for any deficiency if the value of the property is less than the amount of the debt. In similar fashion, if the goods are sold at auction, the debt of the debtor is fully extinguished. Again, the pledgee-creditor has no further claim against the debtor, even if there is a shortfall.[117] This can create an economic disaster for the creditor if the proceeds realized from the sale are significantly less than the total amount of the debt.[118] Moreover, this provision stands in sharp contrast to the laws in the US and other common law jurisdictions, where the creditor is typically entitled to sue the debtor for the deficiency. Further, it is arguable that this restriction is unjustifiable in light of the stringent procedural rules (as stated) with which the pledgee must comply so as to ensure that the sale is not tainted with any collusion that might have distorted the true market value of the property. Neither the legislature nor the courts have fully explained the rationale behind the rule expressed by Article 2115.[119] Conversely, where the sale of the asset yields a surplus, the pledgee is not entitled to retain it, unless such has been expressly agreed between the pledgee and the pledgor.

There is another problem with this remedy. It relates to pledges of intangible personal property, such as shares of corporation, which are popularly pledged. Where the secured shares have to be sold, the creditor has to adhere to the procedure described above, otherwise the sale can be set aside. This is illustrated in *Lim Tay v Court of*

[117] See Article 2115 of the New Civil Code, which provides: 'The pledgee cannot sue the pledgor for the balance, notwithstanding any agreement to the contrary.' Note that this limitation did not exist under the old Spanish Civil Code.

[118] *Ibid.*

[119] See note 131.

Appeals,[120] where in consideration of a loan given by the creditor, the debtor pledged his shares in a corporation with the creditor. The pledge agreement provided that in the event that the debtor (pledgor) failed to repay the loan, the creditor was entitled to sell the shares by public auction or private sale with or without notice to the debtor. It was further agreed that at the sale the creditor was entitled to purchase the shares. However, when the debtor defaulted in the repayment, the creditor merely transferred the shares to creditor's name. The court held that the transfer was invalid and that the debtor remained the owner of the shares because the creditor had not made any attempt to foreclose or sell the shares through public or private auction, as stipulated in the contracts of pledge and as required by Article 2112 of the Civil Code. Therefore, the ownership of the shares did not pass to the creditor.[121]

That said however, the sale of shares by public auction, especially where the shares are listed on the stock exchange, may present certain difficulties. There is typically a time lapse, usually about 3 weeks, between the decision to sell and the date of the auction.[122] The reserve price,[123] in the case of listed shares, is the price quoted on the stock exchange on the day the auctioneer advertises the auction. Owing to the lapse of time, the reserve price may be different from the stock exchange price at the date of the auction. If the stock exchange price is lower than the reserve price the sale has to be abandoned. The creditor is therefore confronted with a high degree of uncertainty and this can have serious implications in conditions of market volatility.

To solve this problem, some standard pledge agreements[124] in the Philippines give the creditor the power to sell the shares by public

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[120] (1998) 293 SCRA 634.

[121] *Ibid*, p 635, per Panganiban J.

[122] Information provided by an Attorney and Notary Public practising in Manila, interviewed by one of the authors.

[123] In *China Banking Corporation v Court of Appeal* (1997) 270 SCRA 503, a reserve price was fixed and at auction the pledgee was the highest bidder and acquired the shares. There was no difficulty here because the issuing company was a private company.

[124] S Guevara, Legal Forms Annotated, Rex Store Inc, Manila, 15th ed, pp 117-123, (1998).

auction or *private sale at its place of business or elsewhere, such as in any broker's board or securities exchange*. The italicised mode of sale seemingly contradicts Articles 2112-2116, which mandate that the sale must be by public auction. However, the weight of authority is against this argument. For instance in *Lim Tay v Court of Appeal*,[125] the Supreme Court refused to condemn such a private sale agreement. Indeed, it found that the creditor should have complied with the agreement. In the earlier case of *Philippines National Bank v Manila Investment & Construction, Inc.*,[126] which involved a chattel mortgage, the court held that such an agreement was valid. It is submitted that this decision was found on commercial convenience rather than on any strict substantive principles because nothing in the New Civil Code expressly authorises such a mode of enforcement.

With regard to the chattel mortgage, s 14 of the Chattel Mortgage Law Act operates a separate regime of rules governing the power of sale of the chattel mortgagee that is distinct from that of the pledgee. This confers on the chattel mortgagee two types of power of sale-namely, *extrajudicial sale* (i.e. sale without court order) and *judicial sale* (i.e. sale with a court order).

Extrajudicial sale

If the chattel mortgagee-creditor decides to sell the collateral extrajudicially, he must act in strict compliance with the following procedural steps contained in s 14 of the Chattel Mortgage Law Act:

- The creditor can only exercise the power of extrajudicial sale on the expiry of 30 days from the date the term of the mortgage is breached.
- The sale must be conducted by a public officer, typically the court's sheriff.
- The sale must be by public auction. It must be held in a public place in the municipality where the debtor resides or where the property is situated.

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[125] *Supra* note 121.

[126] (1971) 38 SCRA 462.

- At least 10 days before the auction, notice of the time, place, and purpose of the sale must be posted at two or more public places in the relevant municipality.
- At least 10 days before the auction, the creditor has to notify the debtor and subsequent mortgagees/creditors, if any, of the time and place of the auction.
- The officer making the sale must, within the 30 days of the sale, make a return of the particulars of the sale and record the same in the Register of Deeds. The return operates as a discharge of the mortgage.
- The proceeds from the sale must be applied in the following order: costs and expenses of the sale; payment of the loan secured by the mortgage; payment of any subsequent mortgages. The balance, if any, should be paid to the debtor.

The above steps, as in the case of the pledge discussed earlier, are intended to ensure that there is no collusion between the creditor, auctioneer and purchaser in the sale of the property, and that the debtor is treated fairly. In the event of a failure to observe any of the foregoing, the creditor may be liable for any damages suffered by the debtor.[127] It has been held that a creditor who, without the consent of the debtor, removed the mortgaged chattel to another province and sold it there in breach of the third step above, was liable to the debtor for conversion to the full value of the chattel.[128] There are, however, two exceptions to these general rules. First, if the debtor consents, the sale may take place at a municipality other than a municipality where the debtor resides or the property situates. Second, the public auction may be carried out by a notary public if the sheriff is not available or the place where the auction is to take place is inconvenient for the sheriff to discharge his duty.

There are certain discrepancies between the application of the power of extrajudicial sale on the part of the pledgee and on the part of the chattel mortgagee. The first is that there is no formal time bar over the exercise of the power of sale by the pledgee. Presumably, the

[127] See *Bachrach v Golingcoa* (1919) 39 Phil. 138.

[128] *Ibid.*

power is exercisable only after the expiry of a *reasonable time*[129] from the date of the debtor's default to repay the loan. In contrast, under the Chattel Mortgage Law Act, the creditor has to wait for the expiry of a minimum period of 30 days from the date of the debtor's default before he can exercise the power of sale. Arguably this is excessive where, for example, the assets consist of perishable goods. The second disparity is that, after nearly fifty years of conflicting views in the first half of the twentieth century,[130] it now appears settled that the chattel mortgagee may sue for any deficiency after the extrajudicial sale. In contrast, the pledgee, as discussed earlier, is denied this right. The prevailing rationale for the special position of the chattel mortgagee is that the property is given as security only and not as full payment of the debt in case of the default of the debtor. Consequently, the chattel mortgagee is entitled to sue the debtor for the deficiency.[131] In *Biscol Savings & Loan Association v Guinhawa*[132] the court, whilst accepting this point, offered further justification. It found that to hold otherwise would be to create a discrepancy between the rights of a creditor who sells goods by judicial order (see below) and one who sells goods extrajudicially. In the first situation, the creditor may ask for execution of the judgment against any other property of the debtor so as to meet the deficiency. However, if the creditor chooses to sell the

[129] To be determined subject to the individual circumstances of each case.

[130] For a negative view, see Manila Trading and Supply Co v Co. Kim (1940) 71 Phil 448. For a positive view, see *Bank of the Philippines Island v Oluntanga Lumber Co* (1924-25) 47 Phil 20, *Ablaza v Ignacio* (1958) 103 Phil 1151, Luis G Ablaza v GH Ignacio GR L-11466, May 23, 1958, and Garrido v Tuazon (1968) 24 SCRA 727. The conflict is traced to the provisions of Articles 2115 and 2141. Article 2115 provides that the sale of the thing pledged extinguishes the principal obligation, whether or not the proceeds of the sale are equal to the amount of the principal obligation, interest and expenses, and Article 2141 provides that the provisions of the Code on pledge, insofar as it does not conflict with the Chattel Mortgage Law Act, shall be applicable to chattel mortgages. The narrow view is that Article 2141 prevails, because the Chattel Mortgage Law Act is silent on whether a mortgagee can sue the mortgagor for the deficiency. Accordingly the mortgagee, like the pledgee, may not sue the debtor for the deficiency.

[131] See *Bank of the Philippines Island v Oluntanga Lumber C, Ablaza v Ignacio, Luis G Ablaza v GH Ignacio*, and *Garrido v Tuazon, supra* at note 124.

[132] (1990) 188 SCRA 642, following *Luis G Ablaza, supra* at note 124.

goods extrajudicially he is denied the right to sue for the deficiency. Perhaps a more tangible reason is that a creditor who pursues an extrajudicial sale should not be punished for his diligence by taking advantage of a more expeditious and cheaper execution process. It is submitted that the court's reasoning is sound, but it begs the question as to why the legislature has not amended the Civil Code and the Chattel Mortgage Law Act so as to clarify and harmonize the respective laws relating to the powers of sale of the pledgee and chattel mortgagee. The same question was raised in section II above in relation to the incorrect definition of a chattel mortgage in the Chattel Mortgage Law Act. In sum, it is evident that the remedy of power of sale is unnecessarily complex and confusing in its current state.

Judicial foreclosure (sale)

In the case of judicial foreclosure, the chattel mortgagee creditor requires to apply to the court for an order of foreclosure. The application of the creditor must set out the following particulars:[133] the names and residences of the creditor and debtor; a description of the mortgaged chattels; a statement of the date of the obligation secured by the mortgage; the names of any other persons claiming an interest in the mortgaged chattels; and the amount claimed to be unpaid. If the court finds that the information is true, it will ascertain the amount due to the creditor and order the same to be paid into court within 90 days from the date of service of the order.[134] Upon default, the mortgaged property will be sold by public auction. Section 8 of the Rules of the Court provides that the creditor must follow the procedure for extrajudicial sale discussed earlier.

There are two major advantages in judicial sale, especially for creditors who have sold equipment and motor vehicles on installment payment terms and the installments are secured by a separate chattel mortgage over the chattels. First, the defaulting debtor rarely delivers the vehicles to the creditor voluntarily. As a consequence, the creditor has to seek the aid of the court for an order of possession in any case.

[133] Section 2 of the Rules of the Court.

[134] *Ibid.*

Second, the creditor may see it as convenient and cost effective to apply for a judicial order of sale at the same time,[135] because if there is any deficiency the creditor is entitled to sue the debtor for recovery. Thus, in essence judicial foreclosure is akin to 'killing two birds with one stone'.

However, these advantages are overshadowed by a serious practical disadvantage: judicial sale is painfully slow[136] and comparatively expensive given the inefficient curial infrastructure in which it operates.[137] Applications are often adjourned because lawyers are not ready to proceed or important documents are missing. Typically, there is a substantial backlog of cases.[138] As a consequence, it is common for the courts to grant the order of foreclosure 12 to 18 months after the date of the application.[139]

There is also a serious practical defect in the power of sale procedure applicable to the pledge and chattel mortgage. The procedure does not work well for mortgages or pledges of uncollected receivables - intangible assets commonly used by banks to secure advances in the Philippines. If the above procedural steps are followed, the uncollected

[135] For examples of this practice, see *Luneta Motor Co v Dimagiba, et al* (1961) 113 Phil 865; *Zaragoza v Dimayuga* (1965) 7 CAR 515; *Supreme Inc v Zshornack, et al* (1968) CAR 793; and *Filipinas Investment & Finance Corp v Ridad* (1969) SCRA 565.

[136] See C Parlade, 'Arbitration is better option for feuding firms than opting for court', (Sep 30, 2002) BusinessWorld, p 1, where the author stated: "Unfortunately, cases are tried for a very long period of time simply because all courts are hopelessly clogged which contributes in large measure to the delay in solving the disputes." The author further estimated that it took the court approximately 3 years to resolve a case. An Attorney in Manila also confirmed the delay but gave a shorter period of 18 months. In any case, both far exceed the official time frame of 12 months for Regional Trial Courts; see website:www.supremecourt.gov.ph. So serious is the problem, the Supreme Court recently took the unusual step of fining two judges for undue delay in deciding numerous cases within the official time frame; see 'Supreme Court Fines Two Judges', website:http://www.supremecourtgov.gov.ph/news.htm.

[137] *Ibid*, according C Parlade, p 2, litigation costs are high when lawyers from established law firms are employed. Legal fees are charged on a per-hour basis and if the case is delayed costs quickly escalate.

[138] One of the authors interviewed an experienced litigation Attorney in Manila, who expressed this view.

[139] *Ibid*.

receivables will have to be sold by public auction. This is commercially unrealistic because the creditor is required to bid at the auction when it would be more expeditious and less costly for him to collect the receivables and settle the debt. To circumvent this problem, the majority of banks seemingly adopt the common law mechanism to secure the receivables. The problem, the solution of the bank, and the stance of the courts on the subject is well illustrated by the case of *Manila Banking Corporation v Anastacio Teodoro Jr.*[140] There, the bank obtained the debtor to execute an assignment of receivables in the form of debts owing to the debtor by a third party (hereafter 'fundholder') in favour of the bank to secure loans advanced by the bank. The fundholder subsequently became defunct and the debtor defaulted in repayment. A question arose as to whether the assignment was a conveyance, in which case the loans of the debtor would be fully discharged, or a security. The latter would be consonant with the concept of assignment by way of security in the US[141] and under English common law.[142] The court held that the assignment created a security. Accordingly, the debtor was liable to repay the loans. However, the judges, Feliciano J and Bidin J, differed on the precise nature of the putative security. Feliciano J concluded that it created a mortgage, but not in the form of a chattel mortgage. He reasoned that the assignment, which was an absolute conveyance of title over the receivables, was for the convenience of the assignee bank. If such an assignment mechanism were not used, the bank would be required to employ a pledge or chattel mortgage. These security devices are, however, inconvenient when the debtor defaults, for the bank, as a general rule, would need to foreclose on the receivables, place them for public sale and thereby acquire them.[143] This process has to be observed, because as stated, Article 2088 of the New Civil Code prohibits a mortgagee or pledgee from simply taking and appropriating the secured property to settle the debt. A deed of assignment by way

[140] (1989) 169 SCRA 95.

[141] See *Corbin On Contracts*, West Publishing Co.,St. Paul, Minn, s 881, pp 541-543, (1951).

[142] See GH Treitel, *The Law of Contract*, Sweet & Maxwell, London, 10th ed, pp 301-304, (1999).

[143] *Ibid*, p 107.

of security avoids Article 2088. Bidin J on the other hand, presumably suspecting that the approach of Feliciano would serve to import the common law concept of assignment by way of mortgage, applied the strict letter of the New Civil Code and held that the assignment created a chattel mortgage because no documents evidencing title were delivered to the bank, an essential of a pledge.

It is submitted that the reasoning of Feliciano J makes commercial sense and that it is in sympathy with the dilemma of the banks. However, on careful reading of the civil law Bidin J is correct for the following reasons. First, the civil law knows not of any form of security devices, except the pledge, chattel mortgage and trust receipt.[144] Second, according to Articles 1624-1635, Chapter 8 of the New Civil Code, an assignment in the Philippines is strictly treated as a sale of the intangible property or extinguishment of the assignor's debt owing to the assignee.[145] This is the essential difference between assignment in the Philippines and assignment in the US and other common law jurisdictions.

It is for these reasons that Feliciano J's decision was not followed in subsequent cases. For instance, in *Integrated Realty Corporation, Raul L. Santos v Philippine National Bank,*[146] the court held that an assignment of a time deposit certificate followed by delivery of the certificate to the lender bank as security constituted a pledge. However, the court did not order the pledgee bank to sell the time deposit by public auction. Rather, the bank (the fundholder) was ordered to pay the deposit to the pledgee bank. It is submitted that this decision appears to contradict the provisions of Article 2088. The fact that it prohibits the creditor from appropriating the things given by way of pledge or mortgage and that it renders any agreement to the contrary null and void, was neither raised before, nor mentioned by, the court. The only exception is in Article 2112, which allows a creditor to appropriate the thing pledged only after two auction sales have been

[144] See *EC McCullough & Co v Zoboli* (1914) 25 Phil 495,497, per Trent J, which constitutes authority for the rule that unless the security instrument is one of the aforesaid, the instrument is null and void.

[145] See *Manila Banking Corporation v Anastacio Jr* (1989) 169 SCRA 95 and *Integrated Realty Corporation v Philippine National Bank* (1989) 174 SCRA 295.

[146] (1989) 174 SCRA 95.

unsuccessful. Again this point was neither raised in argument nor mentioned in the judgment.

There is a practical ramification inherent in the decision as to whether to treat the assignment as a chattel mortgage or a pledge, especially where there is a competing claim from a subsequent party, who has obtained a chattel mortgage. Given that it is unlikely that the purported pledge or chattel mortgage would have complied with the creation formalities discussed earlier,[147] both instruments would be void against the third party's claim. This issue did not arise in *Manila Banking Corporation* and *Integrated Realty Corporation, Raul L. Santos v Philippine National Bank*, but the problem is nonetheless tangible. For instance, **A** bank obtains from its customer-debtor an assignment of a fixed-time deposit with **B** bank. The customer-debtor subsequently creates a chattel mortgage over the same fixed-time deposit with **C** bank and it duly registers the mortgage at the Register of Deeds. In the event that the customer-debtor becomes insolvent, the assignment, for reasons discussed earlier, will be treated as a mortgage or pledge, as the case may be, and is void against **C**'s chattel mortgage. Given this difficulty, many banks in the Philippines are reluctant to grant loans to customers against the security of the customers' current balances with another bank. It is submitted that this has restricted the flow of capital to small businesses, which do not own significantly valuable fixed assets that can be offered as security.

There is one view that the cumbersome remedy of auction of the receivables can be avoided by exercising the right of 'set-off', as conferred by Article 5, Chapter 4 of the Civil Code, entitled 'Compensation'.[148] This provision corresponds with the common law concept of 'set-off'. However, it is submitted that the remedy of compensation is only relevant if the borrower is also a customer-creditor of the bank.

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[147] For example, the pledge must be executed in a formal document in the presence of a notary public and the chattel document must be accompanied by an affidavit of good faith and registered with the Register of Deeds.

[148] One of the authors discussed the problem with the Legal Counsel of Asia Development Bank, Manila. Counsel suggested that the banks in the Philippines usually exercised the right of 'set-off' under section 5, Chapter 4 of the Civil Code in the event of default by the borrower.

It cannot apply if the fixed deposit is with another bank, such as in the case of *Integrated Realty Corporation*.

However, it is arguable that under Article 1306 of the New Civil Code it is permissible for the pledgee-mortgagee and pledgor-mortgagor to agree that the pledged deposits with the debtor be used to settle the debt owing to the pledgee-mortgagee.[149] Article 1306 provides that the contracting parties may establish terms and conditions as they may deem convenient provided they are *not contrary to law, morals, good customs, public order or public policy*. On the other hand, it could also be argued that such agreement is invalid on the grounds that it is contrary to the express provision of Article 2112 of the Civil Code, which requires that receivables are sold by public auction.[150]

V. Conclusion

The foregoing discussion has revealed that the framework governing security over personal property in the Philippines is far from a successful story of doctrinal or jurisprudential fusion between Spanish civil law and US common law. The system under analysis palpably fails to satisfy the majority of ADB tests set out above. This finding is attributable to several fundamental defects. We draw the preliminary conclusion that the current system is both inefficient and susceptible to reform. First, the widely used chattel mortgage cannot secure future advances. Thus, future advances by the same creditor would require a separate mortgage to be created over the same property - thereby increasing the cost of borrowing. That said, if the creditor refuses to grant further advances, the debtor cannot raise additional loan capital on the same property, even if a subsequent creditor is willing and the value of the property exceeds the total advanced. This restriction is further reinforced by the threat of swingeing criminal sanction for any breach of the debtor's negative undertaking with the creditor. In contrast, the pledge could be extended to secure future advances. However, the pledge is not an appropriate instrument in the context of every type of business, and may in particular prove deficient for application

[149] As discussed by one of the authors with a Manila Attorney.

[150] As noted earlier, see subheading 'Foreclosure (Sale)' 149.

in trading and manufacturing businesses, where the assets of the debtor are typically in a constant state of flux. Second, the dual registration system of chattel mortgages at the Register of Deeds of different provinces in special situations causes unnecessary confusion and delay, and increases the costs of search and registration. Further, when viewed in the light of the recent technological revolution, which facilitates the electronic storage of, and search for, records in many jurisdictions, the dual registration system appears primitive. Third, the publicity infrastructure is weak and does not adequately protect the interests of the public. This is a direct result of the haphazard, antiquated and inaccessible filing system currently employed. Fourth, the remedies are limited and the enforcement process of judicial sale is generally cumbersome and expensive. In addition, the amount recoverable by the creditor is uncertain in respect of the pledge. Fifth, there is a disparity of justice between the pledgee and the chattel mortgagee in terms of the right to sue for deficiency after the sale of the secured property. Whereas, a pledgee is not permitted to sue for deficiency, a chattel mortgagee is, generally speaking, entitled to seek full redress. Thus, the legal framework, without concomitant justification, appears to discriminate between different security holders, although the underlying security instruments share common objectives and function - namely, to secure the obligation of the debtor to repay the loan.

Furthermore, the applicable judicial infrastructure is manifestly overstretched. This significantly contributes to the delay in, and high cost of effecting the enforcement of, the chattel mortgagee's remedies of taking possession and sale. In addition, the rules governing the remedies of the creditor, which appear to be pro-debtor, do not draw any distinction between consumer and non-consumer creditors. The former may need more protection than the latter. Arguably, the remedies of the non-consumer creditor should facilitate the recovery of capital without the need to undergo the complex and cumbersome process of public auction. It is submitted that the right of the creditor to dispose of the secured assets by private treaty should generally be implied in every non-consumer credit security. Lastly, although the fastidious security forms of the chattel mortgage and pledge have not posed serious particular technical problems for creditors, they deserve to be simplified and modernized to reflect current practices.

There are, however, some positive aspects of the Philippines' credit security framework. In particular the system's simple and streamlined approach to creating secured transactions over personal property should be applauded. The same set of credit security rules applies to both corporate and non-corporate debtors. Thus, each class of debtor uses the same security devices, namely, the pledge and chattel mortgage. This uniform approach fosters a certain degree of accessibility and transparency in the law.

The pertinent issue is the future shape and direction of reform in the Philippines. Currently, there are five models in the Western economies. These models are commonly called the 'notice-filing system' of security over personal property. Some of the models are already in actual operation, for example, the mechanism established by Article 9 of the UCC of the US,[151] the Personal Property Security Acts of Canada and the Personal Property Securities Act 1999[152] of New Zealand. Other notice-filing models have been proposed by the Australian Law Reform Commission[153] and the English Law Commission.[154] The actual notice-filing systems of Canada and New Zealand, and the proposed notice-filing systems of Australia and England are, to a large extent, modelled on the notice-filing system of Article 9 of the UCC.

Essentially, a notice-filing system contains the following features. First, it aims to provide a simple and comprehensive credit security framework governing security over personal property that is user-friendly, easily accessible, cost effective and reliable. Moreover, it guarantees a unitary approach to personal property secured transactions. Labels such as mortgagors and mortgagees, pledgors and pledgees, owners

[151] Introduced in 1952. It was revised in July 2001. The UCC Revised Article 9 has been adopted by all US states.

[152] As amended by the Personal Property Securities Amendment Act 2000 and the Personal Property Securities Act 2001.

[153] See ALRC Report No 64, Personal Property Securities, (1993) Chapter 4, 'Policy goals and directions for reform', and particularly, Chapter 5, 'Scope of the Regime'.

[154] Consultation Paper No 164, Registration of Security Interests: Company Charges and Property Other Than Land, .(June 2002 June), Parts IV and VII.

and hirers, lessor and lessees, conditional sale sellers and buyers, entrusters and trustees are rendered defunct. These persons are referred to as the 'debtor' and 'secured party'.[155] Third, such a system adopts a functional definition of *secured transaction*. All transactions are regarded as security transactions if in substance they secure the payment or performance of an obligation. Such, a security is enforceable against the debtor when the security interest 'attaches' to the collateral. In simple terms, a security interest attaches when there is a formal agreement between the debtor and the secured party, to the effect that the secured party has given value and that the debtor has rights in the collateral.

Another feature of a standard notice-filing system is that a security becomes valid and enforceable against third parties once a financing statement is filed with the relevant registry.[156] The financing statement describes the nature of the security, the assets affected, the period of the security, and stipulates the particulars of the debtor and the secured party. The general rule is that the priority of competing interests is determined by the date of filing of the financing statement. Notice filing-systems also provide that certain types of subsequent transactions affecting the secured assets, such as the sale of consumer goods in the debtor's ordinary course of business, are free from the claim of the secured party notwithstanding the fact that the security is duly registered. Finally, such a system comprehensively sets out the rights and remedies of the debtor and secured party.

The Philippines' current credit security legal framework already possesses some of the features of the notice-filing system: the date of registration determines priority, the chattel mortgage resembles the floating lien and there is an absence of equitable and legal security interests. Therefore, reforming the Philippines' credit security legal framework along the lines of the notice-filing system may not be as difficult as in the case of certain common law jurisdictions. In this regard, it is submitted that it would be logical and sensible for the Philippines to focus on Article 9 of the United States' Uniform Com-

[155] For example, see s 16, Part 2 of the New Zealand Personal Property Securities Act, as amended.

[156] The exception being where the secured party has possession of the collateral.

mercial Code. The Philippines must also seriously consider reform of its judicial infrastructure. Without an efficient judicial mechanism, substantive reform of the credit security system would ultimately prove meaningless.

In sum, it is argued that wholehearted adoption of the reform programme advocated in this article would derive a modern, efficient and coherent framework for the regulation of credit security in the Philippines. Moreover, such a policy would serve to revitalize the pursuit of those economic ambitions and aspirations so long ago articulated by Johnson J; a pursuit that has been muddied and diffused by a myriad of conflicting factors in recent decades.

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THE EUROPEAN UNION'S CONFLICT OF LAW RULES GOVERNING CONTRACT LAW: A RE-EVALUATION IN THE 21ST CENTURY

An article to examine the effectiveness of 1980 Rome Convention on the applicable law in contractual matters

A. Introduction

Until 1991, the rules for choice of law in respect of contractual obligations were a matter of common law, but the question is now[1] substantially governed by the Rome Convention on the applicable law to contractual obligations 1980, as enacted by the Contracts (Applicable Law) Act 1990.

> "I regard this Bill as unfortunate and unnecessary. It brings into English law the effect of a European Convention in an area that in English law is perfectly satisfactory, has been controlled by the judges and is now to be set into the cement of statutory legislation[2]."
>
> "... This Bill will preserve the principles of our complex rules for contract, and the convention will create a harmonious set of such rules throughout the European Community; in other words, the other member states which ratify the convention will have the benefit of the same principles as those which the courts of this country have worked out...over the years[3]."

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[1] See generally, Dicey & Morris, *The Conflict of Laws* (13th edn. Sweet & Maxwell, London, 2000), chap.32; R.Plender, *European Contracts Convention* (2nd edn., Sweet & Maxwell, London, 2001); P.M.North (ed.), *Contract Conflicts* (North Holland, 1982).

[2] Lord Wilberforce in the debate on the third reading of the Contracts (Applicable Law) Bill. HL Debs. Vol.518, col.438, 24 April 1990.

[3] Lord Mackay of Clashfern, L.C., in the same debate, *ibid.* col.440.