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**Issues of secured transactions and pledges of  
movable property**

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The International Finance Corporation of the World Bank Group, in cooperation with the Mongolian Bank Association, has been implementing a program to enhance the supply chain finance market, especially focusing on the increase of loans and financing secured by moveable assets. For Mongolia, the "Law on Pledge of Movable Property and Intangible Property" was enacted and has been in effect since 2015 becoming one of the most frequently discussed legal relations.

Understanding the legal regulations of such relations and application of the law are essential for the growth of loans and financing secured by movable assets. In particular, this law is an economically significant law that provides a mechanism for securing valuable movable property while maintaining the basic concept of ownership in the Civil Code of Mongolia, thereby providing a mechanism for small and medium-sized businesses to obtain the necessary financial needs. In this regard, the concepts and issues of secured transactions and movable property collateral are outlined herein.

## **Concept on movable property and secured transactions**

### *Movable property*

Properties can be either moveable or immovable. Immovable property is defined as land that is separated by specific measurements and is recognized as an independent property by a certificate of ownership issued by the state, according to the fundamental interpretation of the Civil Code.<sup>1</sup> While, if specified in any law, buildings and structures can be considered immovable property separate from the land. According to the law, **movable property** is any type of asset other than immovable property. If components that used to be a part of immovable property are no longer attached to the land or the immovable property, they can be categorized as moveable property. In practice, the most common types of movable property used as collateral can be listed as follows, including vehicles, equipment, inventories, raw materials, cash flows (receivables, sales contracts, etc.), intangible assets, documents (securities, warehouse documents, claims, etc.), grain, livestock, movable assets connected to immovable property, consumer goods, cash, savings accounts, scientific, literary, artistic works of all kinds, inventions, product designs, trademarks, utility models, etc.<sup>2</sup>

### *Secured transactions*

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<sup>1</sup> Interpretation of the Civil Code of Mongolia, 2020, Ulaanbaatar.,

<sup>2</sup> Bayarmaa.N, Erdenechimeg.D "Pledge of Movable Assets and Intangible Assets", 2017, Ulaanbaatar., pp.5 - <https://legaldata.mn/buteel/pdf?id=312>

Pledge does not exist without principal claims, but, is used as to secure the performance of principal obligation. To put simply, the loan agreement signed with the bank and financial institution is the principal claim, and the sum of the loan and interest amount determine the amount of the claim to be secured by the collateral. A collateral agreement may be entered into as part of the main agreement or may be written as a separate agreement.

## **Basis of the pledge of movable property**

Movable property and intangible assets may be pledged in accordance with the law, or on the basis of a contract, as stated in the “Law on Pledges of Movable Property and Intangible Property”. The right of pledge under a contract arises on the basis of entry into the contract in writing. The pledge agreement shall be concluded between the pledgee or lender on the one hand, and the pledgor or the owner of the collateral item on the other hand. The pledgor, who is the owner of the collateral, may not be the borrower under the loan agreement. On the other hand, the right of pledge under the law shall be effective immediately in the event that the obligor fails to pay taxes or perform other related obligations, and the competent authority shall seize the property owned by that person and collect the payment accordingly under the Laws on Taxation, Bankruptcy, and Enforcement of Court Decisions, without having to conclude an agreement with such person.

Specifically, in the case of contractual pledges, the pledgee has the right to pledge by signing a written pledge agreement between the parties that meets the requirements under the law, thus, the pledge rights are further secured by registering the pledge notice of the contract in the internet-based registry. Therefore, it is crucial to understand the difference between a pledge being created and a pledge notice being registered.

## **I. SECURED LOAN AND COMMERCIAL FINANCE**

### **The importance of secured loan**

There is a direct relationship between risk and cost of credit, and higher the risk, the higher the cost of credit. A secured loan reduces potential credit risk/ increases the chance of repayment of the loan. Risk management is implemented by constantly monitoring the borrower's activities and inserting relevant articles, clauses and conditions in the loan agreement and pledge agreement. If the borrower or obligee fails

to fulfill his/her obligations, the risk will be reduced by exercising the pledge rights of the secured creditor.

For secured creditors:

- In a bankruptcy case, when the properties of respondent are distributed among creditors and claimants by the trustee, there is a higher possibility that some or all of the principal claims of secured creditors are satisfied with the utmost priority.
- Generally, in terms of priority of exercising the right to pledge, secured creditors have priority over the preferred and unsecured creditors.
- The secured creditor's right to pledge is valid even after the collateral is transferred to a third party.
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- Further, despite the sales of the collateral, the right to pledge remains applicable on the proceeds from such sales in the same priority as the original collateral.

This means less risk for creditors, and consequently, a secured loan usually costs less than an unsecured loan. Likewise, borrowing under this framework is less expensive for the borrower.<sup>3</sup>

## **Interrelation between secured loans and other legislation**

### Law on Bankruptcy

Enforcement of the right to pledge by a secured creditor is not carried out separately:

- Typically, it is combined with the claims of other creditors and claimants in the insolvency proceedings of natural and legal persons.
- Currently, the insolvency matters are governed by the Civil Code, Civil Procedure Code, the Law on Bankruptcy, the Company Law of Mongolia and other legislative acts enacted in conformity with them.
- Other legislation: Law on Pledge (Movable and Intangible Property), the Law on Financial Leasing.

Interrelation between the legislative frameworks for secured transactions and insolvency:

- Secured transactions legislation governs the relations regarding claims by

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<sup>3</sup> Tom Johnson, Training on legal regulations on secured transactions and movable assets financing, Lecture 1, pp.,22

secured creditors, and, to a limited extent, the relations between secured creditors, the bankruptcy trustee, and the creditors the trustee represents.

- Insolvency legislation governs the relations between preferred creditors who are entitled to enjoy their right to pledge in the first instance and unsecured creditors, as well as to a limited extent, relations between secured creditors.

## **Commercial financing structures<sup>4</sup>**

### **1) Term loans**

- A specified amount of funds is advanced under the loan agreement for a specific purpose at a set interest rate for a specific period.
- Repayment usually occurs through blended payments that combine interest and principal in an equal monthly amount that is set for the entire term of the loan.
- The borrower cannot usually change the interest rate and cannot usually pay off the loan in advance of the schedule, without the lender's permission.
- The focus of the lender in traditional bank financing is on:
  - the borrower's cash flow as its primary source of repayment;
  - the security interest in the collateral is usually regarded as a source of repayment in the last resort;
  - banks tend to focus on immovable property as collateral, which small and medium-sized enterprises do not often own.

### **2) Asset-based lending**

- Often used to finance the operating cycle for small and medium-sized enterprises.
- This form of financing is usually structured around accounts receivable and inventory, as primary and secondary collateral respectively.
- The borrower uses the cash proceeds from the sale of inventory to repay the loan.
- The maximum amount of money a business can borrow at any given point in time is determined by the "borrowing base".

### **3) Factoring**

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<sup>4</sup> Tom Johnson, Training on legal regulations on secured transactions and movable assets financing, Lecture 2, pp.22.

Factoring is a specialty financing transaction in which the business transfers its ownership in its receivables through an outright sale to a financier, and receives in return an immediate payment, at a discounted value. The “factor” – the financier that purchases the receivables - is usually responsible for collecting the payment on them, and usually bears the loss of non-payment by account debtors - that is, the original borrower’s debtors. Factors provide other services to the originator, including office support, bookkeeping services, credit investigations, and the collection of receivables. To that extent, one could view a portion of the discount as payment for administrative support.

- Unlike asset-based lenders, factors focus their due diligence on the credit risk of the account debtors rather than the originator of the receivables.
- This is because the credit risk, in a factoring arrangement, shifts from the originator to the originator’s customers. In essence, the factor is purchasing a right to a stream of revenue, and its primary focus is on the source of that stream.
- Accordingly, it will conduct due diligence on each account debtor (or a representative number of account debtors) and establish an overall limit for the originator, and sub-limits for each account debtor’s receivable that it purchases.

#### **4) Unit inventory financing**

Unit inventory financing: Usually occurs with large ticket items, such as motor vehicles, construction equipment, agricultural equipment, large home appliances, and furniture. Each loan advance is made against a specific item of collateral. As a dealer sells each item of collateral, the supplier is paid unless an alternate arrangement has been made.

The essence of the dealership business model is to turn over inventory for cash proceeds in a relatively short time. Where cash proceeds are not immediately forthcoming – for example, where goods are sold under a credit arrangement - the floor plan loan agreement is a useful financing structure to finance gaps between:

- the delivery of inventory,
- its time of sale, and
- the cash received from the sale (refer to diagram of business operating cycle)

The dealer purchases inventory from the supplier through the financier’s guarantee of payments to the supplier. The relationship is usually structured through a financier-dealer master loan agreement, a manufacturer-dealer agreement, and a financier-manufacturer agreement. Pursuant to the arrangement in these agreements, the

manufacturer receives payment from the financier at the time of delivery to the dealer, or the time of sale (depending upon the terms of the financing arrangement) for the cost of each specific item of inventory supplied to the dealer. Unlike asset-based lending, the advance rate in floor plan financing is often 100%, and the deferred payment is secured by a “purchase money security interest”.

The borrowers’s focus in floor plan financing is on:

- the time to sale (the “inventory period” in Diagram of business operating cycle); and the proceeds

## **II. INTERNATIONAL BEST PRACTICE**

### *1. An integrated approach*

All transactions that in substance secure payment or performance of an obligation.

*Integration is accomplished through the concept of a unitary security interest.*

- All secured transactions, no matter how denominated, are classified as security interests and are subjected to an identical regulatory framework.
- In place of the various bodies of law governing security devices, there is one device and a basic set of terms.
- In this approach, a security interest is an interest in movable property or fixtures that, in substance, secures payment or performance of an obligation.
- Encompasses every transaction without regard to its form and without regard to the person who has title to the collateral that in substance creates a security interest. Also includes other transactions, such as an assignment, consignment or lease, if they secure payment or performance of an obligation; and a transfer of a receivable or receivable and supporting rights, a commercial consignment, and a lease for a term of more than one year, even if they do not secure payment or performance of an obligation.

### *2. Organizational concept underlying the legislation*

The organizational principles underlying modern secured transactions legislation are based on defined “types of collateral”. The rules in a modern secured transactions regime reflect the expectation of the parties in relation to each of these categories of assets. The “type of collateral” is categorized by the use or intended use of the assets as “consumer assets” or “business assets”.

Types:

1. consumer assets (used for personal or household purposes); and
2. business assets (used in a business enterprise):
  - Goods –subdivided into three categories:
    - (a) goods held by the debtor as equipment;
    - (b) goods held by the debtor as inventory;
    - (c) proceeds (of the sale of inventory or other assets).
  - Financial instruments and documents of title
  - Cash and funds in a deposit account
  - Securities (debt or equity instrument)
  - Intangible assets, such as accounts receivable

The following bullet points are conceptually interdependent. Together they create, functionally, a fixed encumbrance:

- A defined class of (“equipment”, for example, in a business enterprise; consumer goods in a consumer transaction) collateral and assets; In consumer transactions, this defined asset is usually individualized – i.e. a specific asset, intended for personal or household use.
- The ability to capture future assets within that class;
- A prohibition on selling the asset (or assets, if the security interest covers a class of assets) without the prior authorization of the secured creditor;
- If sold without prior consent, the secured creditor has the right to follow the asset into the hands of the third party purchaser;
- The security interest in the original collateral continues in the proceeds of the collateral.
- The proceeds of disposition are automatic perfected if the original collateral was perfected; ;
- The priority of the security interest in the proceeds is the same as the priority of the original collateral.

### **III. CONDITIONS TO BE SPECIFIED IN THE MOVABLE ASSETS SECURITY AGREEMENT**

The movable assets security agreement must be concluded in writing, and the following points must be included in the contract. It includes:

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1. Information on the parties: In case of a natural person, the name of the parent, own name, registration number, and residence address; In case of a legal entity, the registered name, the state registration number of the legal entity, and the residence address.
  - a) Information on the pledgee and the pledgor;
  - b) Information on the obligee, if the obligee is not a pledgor;
  - c) If the collateral is under a joint ownership, information on the joint owners;
  - d) If there are several obligees or pledgees, the information on each obligee.
2. The amount of the obligation to be satisfied with collateral: If known at the time of signing the contract, the amount of the claims to be satisfied with collateral shall be set forth. However, if it is agreed that the obligation to be satisfied with collateral may arise or change in the future, the procedure for determining it and other conditions shall be included in the contract.
3. Definition of collateral: The characteristics of each and type of collateral shall be clearly defined.
4. Person in possession of the collateral: It is necessary to clearly mention who is in possession of the collateral, the pledgee, the pledgor and their legal representatives.
5. Date of signing the pledge agreement: The date and time of signing the agreement and the duration of the agreement shall also be included in the agreement.
6. The pledge agreement shall be signed and authenticated by the pledgee and pledgor, or their legal representatives.

**Resources:**

1. Law on pledges of movable property and intangible property, 2015.
2. Law on Bankruptcy, 1997.
3. Interpretations on Civil Code of Mongolia, 2020, Ulaanbaatar.,
4. Bayarmaa.N, Erdenechimeg.D, Pledge of Movable Property and Intangible Property, Ulaanbaatar., 2017, <https://legaldata.mn/buteel/pdf?id=312>
5. Tom Johnson, Training on legal regulations on secured transactions and movable assets financing, 2022.

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