Publicity in secured transactions law: Towards a European public notice filing system for non-possessory security rights in movable assets?

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Citation for published version (APA):
Hamwijk, D. J. Y. (2014). Publicity in secured transactions law: Towards a European public notice filing system for non-possessory security rights in movable assets?
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Synopsis (summary)
There is a growing call to introduce a European public notice filing system for security rights in movable goods comparable to the notice filing system of Art. 9 UCC. A proposal to this effect has been adopted in Book IX DCFR, which represents a comprehensive framework of rules for proprietary security in movable assets. The ultimate aim of this thesis was to investigate whether a European notice filing system for security rights in movable assets should be introduced, and if so, to what extent Art. 9 UCC should serve as an example. In evaluating this question, this thesis focused on the interests of several types of parties that are typically involved in or exposed to secured transactions operating within the borders of the European Union. In a nutshell, it investigated whether it is likely that these parties will be “better off” in a system where a public filing system exists, measured by effectiveness and cost-efficiency.

More specifically, this thesis proceeded from the proposition that it is worthwhile to strive for public filing if it effectively addresses the legal risks these parties are exposed to in the absence of public information on security interests and does so in a manner that is cost-efficient for the parties concerned, i.e. in accordance with a cost-benefit approach. The outcome was that a public filing system on a European scale may be useful in the aforementioned respect; its success will however, largely depend on the way it is designed and organized. The current proposal for a public notice filing system as embodied in Book IX of the European Register for Proprietary Security ('ERPS'), is promising in various respects. This thesis presented a few recommendations aimed at further improving the proposal.

1. Part I: Scrutinizing the need for publicity

To come to this conclusion, Part I of this thesis examined the need for public information on non-possessory security interests by mapping the problems and risks that the investigated parties are exposed to while conducting trade in a system where public filing is not available, i.e. a ‘non-public filing system’. One of the few non-public filing systems extant in Europe, the Dutch legal system, was used as an exploratory case study to inform the analysis.

1 In evaluating whether a public notice filing is effective, a problem-solving approach has been adopted: I examined if and to what extent a public filing system solved the problems, i.e. mitigated the risks that exist in relation to the investigated parties in the absence of publicity. A certain situation is considered a problem or risk if the investigated parties incur, or are likely to incur, costs caused by the absence of public information on security interests. A certain legal rule represents a solution if it solves the problem, i.e. if it actually mitigates the risk. See supra Chapter 1, subsection D.2.1.

2 The cost-efficiency aspects of a solution were (merely) estimated and mapped on the basis of several 'deciding factors', e.g. the fees that must be paid to make use of the solution (such as search and filing fees), but also the user-friendliness of the present solution and effort that parties must make in order to use it, such as the difficulties in practice of needing to check the register, as well as the time required for updating and the risk of potential errors. See supra Chapter 1, subsection D.2.2.

3 The ultimate aim of this approach is to assess if it is likely that the adoption of a public filing system on a European scale will be economically efficient for the parties that are typically involved in secured transactions and operate within the borders of the European Union; see supra Chapter 2, subsection D.2.

4 The term 'public information on security interests' refers to substantive information on i) who holds an interest, ii) since what particular point in time, iii) in what asset and iv) in what capacity.
There is a growing call to introduce a European public notice filing system for security rights in movable goods comparable to the notice filing system of Art. 9 UCC. A proposal to this effect has been adopted in Book IX DCFR, which represents a comprehensive framework of rules for proprietary security in movable assets. The ultimate aim of this thesis was to investigate whether a European notice filing system for security rights in movable assets should be introduced, and if so, to what extent Art. 9 UCC should serve as an example. In evaluating this question, this thesis focused on the interests of several types of parties that are typically involved in or exposed to secured transactions operating within the borders of the European Union. In a nutshell, it investigated whether it is likely that these parties will be “better off” in a system where a public filing system exists, measured by effectiveness\(^1\) and cost-efficiency.\(^2\) More specifically, this thesis proceeded from the proposition that it is worthwhile to strive for public filing if it effectively addresses the legal risks these parties are exposed to in the absence of public information on security interests and does so in a manner that is cost-efficient for the parties concerned, i.e. in accordance with a cost-benefit approach.\(^3\) The outcome was that a public filing system on a European scale may be useful in the aforementioned respect; its success will however, largely depend on the way it is designed and organized. The current proposal for a public notice filing system as embodied in Book IX of the European Register for Proprietary Security (‘ERPS’), is promising in various respects. This thesis presented a few recommendations aimed at further improving the proposal.

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Chapter 8

this analysis. This examination revealed that the absence of public information on security rights essentially creates two main risks.

One important consequence of the absence of ‘publicity’ is that the debtor is in a position to cause lenders and buyers who intend to obtain a security right respectively to buy the asset, to believe that the assets are unencumbered, while in fact they are encumbered with a security interest or subject to retention of title.\(^5\) This may have adverse consequences for pertinent categories of creditors in several respects. First, it exposes first and second-in-time secured trade creditors, secured lenders\(^6\) and attaching unsecured creditors\(^7\) to a risk of ‘proprietary conflicts’, i.e. conflicts where parties fight for the same (proprietary position in the) asset. This is undesirable if viewed from the perspective of various parties investigated in this thesis, since at least one of the parties involved will lose the proprietary conflict at its expense. Moreover, to the extent that this risk materializes in practice and lenders pass on the costs to their borrowers (i.e. ‘debtors’) in the form of one or more credit surcharges, these debtors pay a higher interest rate for their loans, i.e. incur costs they would not have incurred had publicity been readily available.

Another important consequence of the absence of public information is that the moment that security interests take effect (against third parties) can be antedated fraudulently.\(^8\) This entails a risk for all (secured and unsecured) creditors of the debtor except the defrauding creditor itself, since the latter, by committing such fraud, feathers its nest at the expense of the debtor’s other creditors. This causes the parties investigated in this thesis both to incur costs and sustain actual loss or damages, which would had been avoided had publicity been available.

The Dutch case study did not only allow us to identify these risks, it also provided additional insight into the extent to which these legal risks materialize in legal practice and, as a consequence, the extent to which they contribute to costs. As both legal risks find their basis in either fraud committed by the debtor (or by both the debtor and its secured lender) or in incidental errors, it seems fair to conclude that such risks will only materialize incidentally. As a result, on average, the resulting unnecessary costs and

\(^{5}\) Such deceit may occur deliberately, but the debtor may also be mistaken as to whether its assets have been pledged at all, or – in more complex transactions – which ones.

\(^{6}\) If the debtor offers certain (already encumbered) assets for collateral, second-in-time secured lenders and trade creditors (‘C’s) may not be protected by a third party protection rule because they do not satisfy the legal requirements, leaving them second in ranking or empty-handed. If they do meet the requirements for bona fide protection, this conversely entails a risk for first-in-time secured lenders and sellers (‘A’s): namely, that they may lose their interest or their ranking in the asset.

\(^{7}\) Unsecured creditors run the risk of becoming involved in a semi-proprietary conflict when they attach (part of) the debtor’s assets that have already been encumbered with a security interest. This is not a direct result of the debtor’s misbehavior and in that sense this proprietary conflict is of a slightly different nature. The lack of publicity prevents them from avoiding unnecessary attachment costs given the fact that they are not warned about the fact that these assets are worthless from the perspective of recovery.

\(^{8}\) This is not the case if the creation of undisclosed non-possessory security is subject to a requirement to ensure date-certainty, such as in the Netherlands. See supra Chapter 3, subsections 2.2.3-2.2.4.
potential damage for the parties affected by such fraud are unlikely to be significant.\(^9\)
Hence, if the Dutch legal system was representative for all other EU-member states, in
order to justify adoption a public filing system should – in addition to effectively
addressing the legal risks above – meet a rather high minimum standard of efficiency in
doing so. European literature shows that as far as the nature of the problems is concerned
as discussed in this chapter, clear parallels can be drawn between the Netherlands and
other EU-jurisdictions. However, not having expanded my research to all other EU-
member states, it is unclear whether the Dutch results justify extrapolation to the EU as a
whole: conceivably there may be differences in the extent to which the described
problems and risks materialize in practice. With that caveat, Part II and Part III of this
thesis will investigate whether Art. 9 UCC and Book IX DCFR meet this rather high
standard.

2. Part II: An examination of the U.S. approach: Art. 9 UCC

Part II of this thesis evaluated to what extent Art. 9 UCC, the model law that is often
mentioned as the prime example for future European secured transactions law, solves the
problems or mitigates the risks that exist in a non-public filing system (as found in Part I
of this thesis), and if so, at what cost and what degree of effort for the parties exposed to
these risks. More specifically, Part II reported on both the ‘effectiveness’ and the ‘cost-
efficiency’ of the Art. 9 UCC rules and its notice filing system in preventing ‘proprietary
conflicts’ on the one hand and the risk of ‘fraudulent antedating’ on the other. As to both
the aspect of ‘effectiveness’ and ‘cost-efficiency’, the examination of Art. 9 UCC and its
public notice filing system produced a somewhat mixed picture.

2.1. Effectiveness of Art. 9 UCC (Yardstick I)

2.1.1. The risk of proprietary conflicts

The Art. 9 UCC approach to proprietary conflicts can be considered ‘effective’ in the
sense that it gives first-in-time secured lenders and sellers the opportunity to file security
rights or purchase money security interests (‘PMSIs’) in the Art. 9 UCC filing system. As a
result, these filings can warn prospective third parties about the existence of their
(conditional) security rights when the latter attempt to lend against, buy or seize the assets,
thereby avoiding proprietary conflicts between these parties. However, it is interesting to
note that the avoidance of proprietary conflicts has not been given maximum effect under
U.S. law. For instance, many U.S. states do not offer judicial lien creditors the possibility
to file their judgment lien placed on the assets, leaving these judicial liens undiscoverable

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\(^9\) This precise analysis does not equally apply to attaching unsecured creditors, given that these creditors do
not become involved in the same proprietary conflict in the sense that the debtor has not misinformed
them. In other words, the nature of the legal risks they are exposed to is different: they are not defrauded.
As a result, the number of cases that unsecured creditors attach already encumbered assets may be less
small, although no accurate figures to document this are available.
vis-à-vis prospective lenders or other parties. Also, most PMSIs are untraceable until the moment they are filed, which can take up to 20 days after their ‘creation’. Furthermore, to the extent that proprietary interests are filed (timely), and hence are discoverable in theory, the Art. 9 UCC filing system has turned out not to be the gateway to ‘further information’ (concerning the status of the debtor’s assets) for every type of creditor. Attaching unsecured creditors, for example, will not have the leverage to ask the debtor or secured parties to provide further details of any proprietary rights they purportedly hold. In practice, the only searchers that have such leverage are those that the debtor needs to keep its business running: lenders. As a result, and assuming that ‘third parties’ can only make informed decisions by establishing the exact scope of any proprietary rights they purportedly hold, Art. 9 UCC does not effectively prevent all types of proprietary conflicts.

2.1.2. The risk of fraudulent antedating

The risk of fraudulent antedating is only partly prevented under Art. 9 UCC. It is largely contained by the fact that security rights do not have third party effect until a notice of their existence has been filed in the public filing system. As a result, the moment from which a security right can be invoked against prospective third parties is objectively verifiable. In addition to being objectively verifiable, this moment cannot be manipulated in any way, as entries in the filing system cannot be altered. This means that between lenders, where priority conflicts are mainly settled on the basis of the file date, antedating is impossible. In addition to preventing fraudulent antedating, this first-to-file-or-perfect rule – constituting a so-called ‘pure race statute’ – quashes the incentive to commit such fraud in the context of proprietary conflicts between successive lenders. This is explained by the fact that this rule affords secured lenders the possibility to create a conditional superior interest in (part of) the debtor’s asset(s) by filing a financing statement with regard to the assets, even though the security interest has not yet attached. Hence, as long as the description of the collateral in the financing statement is formulated ‘broadly enough’, prospective lenders are ‘on notice’ of the fact that first-on-file lenders may attach a security interest (or several) at a later time or date. Consequently, ‘antedating’ is not a relevant concept when considered only in the context of achieving priority between successive secured lenders, which is solely determined by the order of filing (although the cynical view is that advance filing achieves nothing more than legitimizing fraudulent antedating). The order of filing does not take into account whether or not the security has actually been created. This may work well if imposed as a rule between secured lenders amongst themselves. It leads to complications when rights of others come into play. For example, there is room for antedating in circumstances where a lender holds an earlier filing and may have put the debtor in funds in anticipation of authentication of the security agreement but is confronted with an intervening levy on the collateral concerned, or even a bankruptcy of the debtor, prior to having achieved attachment of the security. A
similar principle applies in relation to subsequent buyers outside the ordinary course of business. In these situations, lenders may not only have an interest in antedating the security agreement or in manipulating the moment the security attaches, but they may also be in a position to commit such ‘fraud’, given that the moment of attachment is not a public matter and the requirements for authentication are not substantial. Hence, Art. 9 UCC does not effectively exclude the risk of fraudulent antedating altogether.

2.2. Cost-efficiency of Art. 9 UCC (Yardstick II)

To the extent that Art. 9 UCC does prevent proprietary conflicts and fraudulent antedating, the Art. 9 UCC filing system is not particularly user friendly. Parties involved in or exposed to secured transactions have to make considerable effort and incur significant costs in order to use or rely on the filing system. Most of the difficulties relate to searching under the debtor’s name and the fact that there is (still) no consistency between the varying search logics used by filing offices in different U.S. states. This forces searchers and filers to use many possible name variants of the debtor’s name to identify pre-existing security interests. In addition to the cumbersome process of determining (and searching under) the debtor’s correct name, it takes time and effort to sort out the false hits when names on the financing statements are similar to one another. State-specific attempts to eliminate ambiguity in the debtor-name standard have led to even greater differences among states and thus ambiguity reigns supreme. In addition to engaging in much filing and search activity, filers and searchers have suffered from a great deal of commercial uncertainty over the past decades, and they still continue to do so. Furthermore, the process of making ‘further inquiry’ is also not so simple. Identifying the right lender and having existing filings terminated proves to be cumbersome, time-consuming and costly in practice. Last but not least, the nature of the filing system entails that filers and searchers have to update and monitor information in financing statements in the filing system after the filing process has been completed to mitigate the risk of becoming unperfected. Both first-in-time and second-in-time creditors must, for example, continue to monitor whether there has been a change of name, whether there has been a relocation of the chief executive office from one state to another and whether the debtor has sold part of its collateral without permission. These are all obstacles to the prevention of proprietary conflicts in a manner that is cost-efficient for the parties concerned. Although an attempt to assess the exact amount of these costs falls outside the scope of this thesis, there is ample literature supporting the view that the costs associated with an Article 9 filing are not trivial. In addition to many filing and search costs resulting from the need to make multiple filings, parties incur high litigation costs and insurance costs in their attempt to mitigate the above-mentioned risks.
3. Part III: Towards a European public notice filing system?

Part III of this thesis first evaluated the research results related to Art. 9 UCC in light of a possible future European filing system. It affirmed that the European legislature should not be discouraged from adopting a ‘European equivalent’ of the U.S. notice filing system for two reasons. The first is that the Art. 9 UCC basic framework provides, to a very large extent, the tools to prevent most types of proprietary conflicts and fraudulent antedating. The second is that many of Art. 9 UCC’s deficiencies are attributable to the manner in which its filing system was implemented in the United States. Hence, many of the shortcomings associated with Art. 9 UCC can be avoided by making other policy choices and by implementing the ERPS more efficiently than Art. 9 UCC.

The Book IX drafters are cognizant of this point: under its current design, on balance, Book IX clearly prevents proprietary conflicts and fraudulent antedating more effectively and efficiently than its U.S. counterpart. The two most notable plus points of Book IX are, in my view, the rules that give registered lenders a stronger incentive to provide further information concerning their collateral on the one hand and the efficient design of the proposed ERPS on the other. Hence, besides for their optimum use of modern technology, the Book IX DCFR drafters have clearly learned from some of the challenges faced by their counterparts in the U.S. under Art. 9 UCC.

Yet, alas, like most of us, Book IX is also not perfect. Under Book IX too, certain types of claims are not made public by filing at all, certain types of security are filed only at a later point in time, or can be made effective against third parties other than by filing, such as by taking possession. This may leave these interests untraceable, as they will not appear in the filing system. Several of these imperfections deserve reconsideration. One may, for example, consider including attachments in the ERPS and abolish taking possession as a means of perfection. Moreover, I believe that the position of attaching unsecured creditors should be improved. In the process of adopting a public filing system on a European scale, it would even be possible and worth considering to push the envelope and design the ERPS for the purpose public filing was originally designed for: to make public the creation of ‘security’. For this to happen, we would have to reconsider the need for advance filing. I believe that modern technology enables us to create a filing system that keeps both fake and empty (but authorized) filings out of that filing system, without at the same time compromising the effective and cost-efficient prevention of proprietary conflicts and fraudulent antedating.

Whether Book IX DCFR after its implementation (whether or not amended by the proposed improvements) will, in addition to enhancing cross-border trade,\(^\text{10}\) be likely to

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\(^{10}\) I remind the reader that this thesis does not focus on whether or not the adoption of a European public filing system would improve cross-border trade as such. This thesis explores whether a public filing system on a European scale would, in addition to enhancing cross-border trade, be likely to produce efficiency benefits for parties that are generally involved in secured transactions and operate within the European Union. See supra Chapter 1, subsection E.3.
produce efficiency benefits for parties that are generally involved in secured transactions and operate within the European Union, cannot be determined with certainty. It must be clear that the considerations of ‘efficiency’ for the parties using (and relying on) the filing system is not the only issue to tip the balance. The fact that many countries in and outside Europe have adopted some form or notice filing, should influence the decision to adopt a public notice filing system on a European scale. Creating a level playing field, for example, will undoubtedy produce indirect economic advantages. Should the European legislature proceed to adopt a European notice filing system and thereby take the current Book IX DCFR proposals as a guideline, the findings of this thesis could provide relevant and concrete suggestions to design this system as effectively and efficiently as possible.