LAW AND ECONOMICS WORKSHOP
FALL SEMESTER
AUGUST 24, 2015

SECURED CREDIT

FREDERICK HELSEN
UNIVERSITY OF LEUVEN, BELGIUM
§1. Introduction

This workshop will focus on the evolution in secured finance towards public registration of security interests. These accompanying materials, however, will start by providing an introduction into the economic underpinnings of secured finance, which will in turn be used to explain the current evolutions in the law of secured lending.

In order to truly understand the law of mortgages and liens, we must start by looking at the way the credit market works. The credit market is a peculiar one, subject to the market failure known as credit rationing: loans are relatively cheap and a lot of people want one, but not everyone gets approved. You would think that, in a situation where demand exceeds supply, the price would rise to clear the market, but it turns out not to work that way. The key to understanding why is adverse selection and moral hazard.

Security interests are a response to these problems of adverse selection and moral hazard, and are designed to target their very foundations. Unfortunately, security interests come with their own set of problems, which will be discussed below. Basically, they can be used to extract value by putting a favored creditor ahead of others, to the detriment of the latter.

In order for security interests to do their job of supporting the credit market, as well as to minimize their drawbacks, the legal system must be designed with these functions and threats in mind. This discussion will bring us to the second part of the workshop, in which we will look at the principles that are emerging as accepted wisdom on the optimal design of the security system.

§2 and §3 will give you a brief overview of the complicated scholarship on secured lending theory. §4 will give a very short recap of the essentials necessary to understand the discourse of §5, which will discuss the main legal focus of this session: publicity systems and their economic foundations.

§2. Basic problem: Adverse selection and moral hazard causing credit rationing:

We all know the basics of economics: supply meets demand through mediation by the price. However, in the credit market, this mechanism which we take for granted doesn’t work as simply as that, and credit is rationed. This means that lenders set a certain interest rate (the price of the loan), and subsequently supply a smaller aggregate loan size than the one demanded by the borrowers. This constitutes market failure, as supply fails to meet demand, and leads to welfare losses. Credit rationing can be explained as a market response to problems of adverse selection and moral hazard.

The basis of the adverse selection problem, also known as the lemons problem, is the inability to distinguish between different categories of risk in a pool. As a consequence, prices are set in accordance with the average risk in the pool, inciting the good risks, which are now being overcharged, to drop out, causing the pool to deteriorate until eventually, the market breaks down. Two textbook examples of this phenomenon are insurance and second-hand cars, of which the first most closely resembles the credit
market. Consider the case of car insurance. A pool of applicants approaches the insurer. The insurer knows that some of them will be good drivers, and others bad ones. He even knows, *on average*, what the accident risk is for the drivers as a pool\(^1\), but he can’t tell *specific* good drivers apart from bad ones. The seemingly logical thing for him to do would be to calculate the insurance premium based on the average risk in the pool. However, the individual drivers in the pool do know whether they are good or bad: this information is asymmetrically distributed. The good drivers will therefore realize they are being overcharged, and are effectively subsidizing the bad drivers, and if possible, will leave the pool, which will reduce the average quality of the pool, leading to an increase in the premium. Those drivers who used to be average risks now become relatively good risks, who will also realize they are being overcharged, etc. This adverse selection carousel will eventually bring down the entire market, because in the end there will only be bad drivers left, unless it is stopped.

The same phenomenon is likely to occur in the credit market: lenders are faced with a pool of prospective borrowers, each having their own risk of default. Let’s assume for now that the lender is completely unable to estimate the risk of default of any *specific* loan applicant, and only has information on the average risk of default of the pool. If the lender sets his interest rate as a function of the average risk in the pool, the adverse selection carousel will be started. Instead, lenders apply a two-track strategy to prevent this from happening. First, they limit the supply of credit to the market, and offer this credit at a low interest rate; they ration credit.

Keeping the price low protects the average quality of the pool through a variety of mechanisms, the main intuition being that low interest rates are positively correlated with low-risk, low-yield projects. Keeping the financing cost for these projects low allows them to stay in the pool. Second, they try to distinguish prospective borrowers according to their risk as well as they can. One of the ways in which lenders try to assess and handle this risk of default, is by negotiating security interests to secure the granted loans. Under certain conditions, these security interests will mitigate the effects of adverse selection.

The term credit rationing *sensu stricto* refers to those circumstances where among loan applicants who appear to be identical, some receive a loan and others don’t, and the rejected applicants wouldn’t even be granted a loan if they offered to pay a higher interest rate. Indeed, unsatisfied borrowers, whose demand for funds far exceeds supply, will offer to pay a higher interest rate, and yet will still be denied loans because paradoxically, the expected return from these higher interest loans is actually lower, due to a consequent increase in the default rate, as these high interests would attract bad risks. The higher interest rates' positive effect of increasing income as compensation for increased default risk, is counteracted by two negative effects: the sorting effect and the incentive effect. The former refers to the fact that higher interest rates sort in favor of higher risk loan applicants on an ex ante basis, as low-risk borrowers are pushed out because their safe projects have insufficient yield to support the higher interest rate. The latter is a matter of ex post changes in behavior, as higher interest rates increase the relative attractiveness of

\(^1\) This knowledge is a product of his experience dealing with drivers, and progressively, from dealing with this particular pool of drivers.
riskier projects. This is closely linked to moral hazard, and can be explained intuitively by looking at the asymmetry in payoffs between the lender and the borrower. In a very stylized model, if the project succeeds, the borrower enjoys the return from the project minus the interest rates. If the project fails, he’ll declare bankruptcy and get nothing, which is exactly what he had before he got the loan. Therefore, the borrower is only interested in what happens when the project succeeds. Higher interest rates decrease his return, pushing him to riskier, higher-yield projects, as he doesn’t have to take account of the possible losses. However, the net return to the bank of this loan may very well be negative, again as a consequence of this asymmetry: if the project succeeds, the bank will only earn an interest rate of a few percent, whereas if it fails, it will lose the entire loan principal.

A second important risk-related cause of credit market failure is moral hazard. This well-known phenomenon occurs when a person who doesn’t have to bear the (full) costs of a risk materializing, as a consequence behaves in a way that increases the risk. In the credit market, the lenders will foresee this and raise their prices, or refuse loans, accordingly. Here too, security interests can play a role in reducing moral hazard, but come at a certain price in terms of moral hazard.

§3. Secured lending: the age-old answer to credit rationing:

For as long as there has been money, there has been borrowing. For as long as there has been borrowing, there has been collateral. The question at issue here is: what exactly does collateral do? Does it reduce credit rationing? And if so, does it do so in an economically efficient way?

In the following sections, a number of theories concerning the functions and dynamics of secured lending will be briefly outlined.

A. Ex ante: credible and efficient information gathering to reduce information asymmetry

1. Information conveyance: Signalling and screening

It is plausible to assume that the borrower will often have better information about his own risk of default than the lender can obtain on his own. If this is the case, the granting of certain security interests, in the broad sense of the word, can be used to credibly signal that quality to the lender. The key here is the credibility of the signal, because every prospective borrower has an incentive to present himself as a great risk, in order to lock in a lower interest rate.

A classic example of using security interests to credibly convey low default risk, is the grant of a personal guarantee, or a security interest in a personal asset, by the manager of a small company. If the company defaults on the loan, the manager will be on the hook for the deficit. Ex ante, this will incentivize him to use this instrument only when he
actually believes the risk is low: this ties into adverse selection. Ex post, the manager will have an incentive to make sure the risk stays that way: this ties into moral hazard.

2. *Specialization and centralization benefits in the gathering of information*

A second way in which collateral can help the lender meet his need for information, is by changing the very information he needs. The basic problem is that assessing the risk of lending to a certain enterprise or person is difficult. Industries and markets are highly variable and sometimes have uncertain futures. The same applies to the individuals on whose skill and work ethic repayment of the loan will largely depend. To the extent, however, that the debt is covered by security interests in collateral, the risk of the loan is shifted from the enterprise\(^2\) to the value evolution of the collateral asset. As long as the collateral secures enough value, then any value the enterprise brings is an extra benefit.

In many cases, the lender will be better equipped to gather and use information to assess the value evolution of the collateral, than to do the same for whatever myriad enterprises their prospective borrowers want to see them finance. In short, collateral is often much easier to value than a business, and the resulting savings in cost, and increase in accuracy, are a benefit which can be divided between the parties.

**B. *Ex post: dealing with collateral devaluation and agency problems***

1. *Monitoring collateral*

Whether or not security interests are used, the assets belonging to any debtor are of great importance to his creditors. Together with the debtor’s earning capacity, they will determine his solvency. Creditors therefore have an incentive to monitor their debtors’ assets.

Granting security interests in certain assets to different creditors can serve as a means of assigning monitoring efforts by those creditors to those assets. This allows them to focus on specific assets, rather than trying to monitor everything. Opponents of this type of efficiency theory will claim that the savings in monitoring costs the secured creditors enjoy are offset by equal additional monitoring costs the unsecured creditors will have to expend as a consequence. Efficiency benefits can, however, be created if there are benefits of scale to this kind of monitoring, differential monitoring ability among creditors, and, subject to certain conditions, when unsecured creditors can free-ride on the efforts of the secured creditors. If, however, the free-riding effect becomes too significant, it will impede any monitoring from occurring. The security interest essentially designates a creditor as the delegated monitor, overcoming the coordination problems which usually plague expensive efforts with limited benefits to a widespread group of actors. Security interests can also reduce the cost of this kind of monitoring. A

\(^2\) I use “enterprise” here as a broad generic term to cover any purpose the borrower needs the credit for, commercial or non-commercial, professional or non-professional, from starting a company, to developing a new product within a company, to a consumer buying a house or a car.
good publicity system for collateral, for instance, can make it harder to disperse encumbered assets to third parties, and allow the assets to be monitored from a distance.

2. Moral hazard: monitoring the debtor

The agency cost of debt is a well-documented problem. The basis of the problem is this: after taking on debt, the debtor can divert value away from his creditors in the four following ways.

- Distribute assets to the shareholders through dividends or stock repurchases.
- Issue more debt of the same or higher priority, diluting the initial creditor’s claim unless (if the new debt has the same priority) the additional credit increases the present expected value of the company at maturity in at least an equal amount.
- Increase the risk of firm assets: once the initial loan has been granted, the debtor has an incentive to change course towards more risky activity, even when that reduces firm value, as long as it increases equity value. Investment opportunities with high payoffs if successful, yet low chances of success can only benefit the debtor. If it works out, he will enjoy most of the benefits. If not, the creditors will bear the costs.
- Underinvestment problem: if the debtor entity already has a lot of antecedent debt, it might forego viable investment opportunities. The profits from this viable investment would be diluted by the old debt, making it harder to find outside financing. Furthermore, the antecedent debt makes it less likely that any profit from the new investment would make it to the shareholders, who will therefore be disinclined to pursue this investment in the first place. As a consequence, the investment will not be made, even though it would be a profitable one.

Lenders are aware of these agency costs, and will monitor their debtors to reduce them, or to the extent possible, will raise their interest rates or reduce the availability of credit accordingly. Security interests can be used to reduce these monitoring costs in various ways.

In general, the theory of the delegated monitor also holds when it comes to monitoring the debtor. If there are benefits of scale to monitoring, or other forms of differential monitoring skill, security interests can be used to assign the task of monitoring the debtor to whichever creditor is most suited for the job.

As far as direct distributions to the shareholders are concerned, security interests in the key assets of the company can make distributions of these assets, or liquidations followed by a dividend payment of their value, much more difficult. The same applies to the issuance of new debt of equal or higher priority. The secured creditor will be able to challenge the conveyance to the shareholder, the sale to a third party, or the granting of new security interests of equal or higher rank based on his rights pursuant to the security
interest.\textsuperscript{3} The extent to which these rights can be enforced against third parties acting in good faith, however, differs by jurisdiction, and is in part dependent on publicity, which will be discussed later.

When it comes to curtailing the freedom of the debtor to increase the risk of his activities, lenders can reduce the threat of asset substitution required to support this reorientation of the debtor’s operations by taking security in assets bespoke to the current activity. The debtor will automatically be hampered in his ability to retool, and therefore to change his business to a more risky one.

And finally, security interests can tackle the underinvestment problem. The reason why a new financier would refuse to finance an investment which, in and of itself is a viable one, is because the profits would be diluted by the old, overhanging debt. Indeed, all unsecured creditors enjoy the same priority, and share pro rata. By granting a security interest, the later lender can be placed ahead of the line, effectively reserving the profits form the project to serve the debt financing it (this result can be reached through a variety of security structures).

\textbf{C. Covenants are usually insufficient}

A typical criticism of the efficiency functions of security interests is that bond covenants can serve the same purpose at lower cost. The claim that bond covenants are equally suited to perform various functions of security interests, but do so at a much lower cost, is commonly made in theory, but is often unpersuasive.

A lender can indeed negotiate a number of covenants to counter the problems outlined above. Indeed, many lenders use a wide variety of covenants in their loan agreements, imposing certain behaviors upon their borrowers, and requiring them to refrain from others.

However, such bond covenants are not self-enforcing, nor are they enforceable in and of themselves in bankruptcy in most jurisdictions. Indeed, such covenants are mere contractual agreements between the parties, and are therefore not enforceable against third parties. For instance, if a creditor is worried about a debtor disposing of a durable asset that incorporates most of the value that might be seized in case of default, to turn it into cash which is easily dispersed and embezzled, he might negotiate a covenant prohibiting this sale. If the debtor ignores this covenant, however, and subsequently defaults on the loan and goes bankrupt, the asset will already be gone, and often, so will the money. Even if the creditor can trace the asset to the purchaser, he will not be able to avoid the sale, and the debtor is insolvent.

Therefore, effective enforcement of such covenants requires substantial monitoring costs, exactly the kind of expense that security tries to avoid. Indeed, as the covenant can only

\textsuperscript{3} The legal set-up of security interests varies, but they invariably entail a right to “follow” the collateral in the hands of other recipients, a right which can then under certain circumstances be defeated by e.g. bona fide purchase doctrines.
be enforced against the debtor, enforcement must be pursued before the debtor becomes judgment proof. This requires effective enforcement before the debtor is accorded bankruptcy protection and/or has become insolvent, and therefore implies close monitoring, as these covenants will only be needed in the vicinity of the debtor’s insolvency.

Security interests, on the other hand, are enforceable against third parties, inside or outside of bankruptcy, and are often self-enforcing to boot. As a consequence, they require far less monitoring than covenants do. These essential qualities set security interests apart from regular contractual constructs, and are key to understanding their added value.

A more pragmatic approach therefore holds that security interests and covenants are best used in conjunction with each other, using the former as a weapon of last resort in bankruptcy, and the latter as a means to exert more control over the debtor during operation.

**D. Drawbacks of security interests**

The inevitable corollary of the benefits discussed above, is the fact that security interests come with their own set of costs, drawbacks and disadvantages, some of which can be summarized as follows:

- **Transaction and enforcement costs.**

- **Inefficient extraction of value from unsecured creditors:** the value that accrues to secured creditors basically comes out of the pockets of unsecured creditors: security reserves assets for the satisfaction of secured claims, in which the unsecured creditors would otherwise share pro rata. To the extent that these unsecured creditors cannot adjust the terms of their claims to this fact, for instance by charging higher interest rates, the granting of security by their debtor expropriates value from them. Essentially, the debtor and his preferred creditor get together and agree to reduce the value of other creditors’ claims in order to increase the value of that preferred creditor’s claim. The problem, from a social efficiency perspective, is not so much the shifting of value, but the fact that the parties to the security interest have an incentive to do so even when some value is lost in the process.

- **Security interests are commitment mechanisms:** they allow a debtor to credibly commit to repaying a debt, or to hold on to a durable asset. By tying his hands, the debtor makes that commitment much more credible. However, doing so also reduces his flexibility in making business and investment decisions, which opens up the possibility of opportunity costs.

- The bulletproof protection a lender seeks when requiring security can also backfire socially, in much the same way as limited liability. When a lender is
perfectly protected by security interests, his incentive to audit the investment project before lending, and monitor it during the course of the loan, is strongly reduced. This could allow inefficient start-up or continuation of projects, with financial fallout imposed on others. After all, the borrower’s bankruptcy isn’t the lender’s problem because he has security.

- The change in hierarchy brought about by granting security to some while others are to remain general unsecured creditors can also skew the incentives of the borrower. The increased power vested in the secured creditors can cause the debtor to give them preferential treatment at the expense of the unsecured creditors and other stakeholders. Last-minute payments and sweetheart deals before bankruptcy tend to go to those creditors who hold personal guarantees given by the manager.

§4. The basics necessary to understand the importance of publicity

A. Overview

Security interests have benefits and drawbacks, which are tied to the more general problem of credit rationing, as discussed above. The publicity principle, found in legal systems around the world, holds that the encumbered nature of a debtor’s assets must be transparent to some degree. Of course, that degree varies between systems, types of assets and the type of security mechanism; some systems require that the secured creditor take possession of the collateral, others require that the security interest be registered in a public register, there are instances where the property interest must be made apparent through the physical attachment of a notice to the collateral,… And of course, in every system there are exceptions and circumventions.

This publicity principle primarily serves two functions: the reduction of the scope for inefficient value extraction from non-adjusting creditors, and the strengthening of security interests in the face of bona fide purchase challenges.

B. Extracting value from non-adjusting creditors

The first function relates to the extraction of value from unsecured creditors mentioned above. Security interests allow a debtor to get together with one of his preferred, or more powerful creditors, and come to an arrangement that will benefit them both, at the expense of someone else. The debtor is made better off, because he will get more credit at a lower interest rate. The creditor is made better off because his claim is more secure. If the debtor defaults, he will be the first to satisfy his claim from the encumbered assets, and whatever is left over goes to the unsecured creditors. Those unsecured creditors, however, are made worse off: rather than share pro rata in the full value of the collateral, they now have to share pro rata in the leftover value. In most cases of insolvency, that leftover value is scarce to nonexistent. After all, companies usually don’t declare bankruptcy when they have a good equity cushion.
Let’s look a little closer at these unsecured creditors, who are at risk of footing the bill. Some of them will be able to compensate for the increased risk they are made to bear, by adjusting their lending terms, such as primarily, the interest rate. Others, termed “non-adjusting creditors”, will not do so, and they will indeed pay for the benefits that accrue to the secured creditor and the debtor. These include involuntary creditors, such as tort claimants and the IRS, and voluntary creditors who could theoretically adjust their lending terms, but decide that doing so would be too costly. Typically, these are creditors with small claims on the debtor, such as trade creditors. In order to adjust their terms, they need to know about past encumbrances made by their debtor, and the search costs of obtaining this information are often prohibitive.\(^4\) They therefore decide rationally not to adjust to the exact financial structure of their debtors.

Giving publicity to the existence of security interests lowers that information cost, and thereby allows more creditors of the debtor to take the consequences of such security into account. By doing so, they effectively force the debtor to internalize the consequences of his lending on a secured basis. As a consequence, the debtor is disincentivized from granting security where doing so would be socially inefficient, but beneficial to him.

It is the second category or rationally non-adjusting creditors where an effective publicity system can reduce inefficiency. The easier the publicity system makes it to investigate the title of the assets belonging to the debtor, the cheaper it is for creditors to do so, and the smaller this category of rationally non-adjusting creditors will be.

**C. Destroying good faith of third party acquirer**

Obviously, the point of taking security is that it must be secure. This is not as tautological as it may sound, because security interests will often conflict with other interests, and when they do, they sometimes lose.

The case in point of interest here is the transfer of the collateral by the debtor to a third party in violation of the terms of the security agreement.\(^5\) In legal systems around the world, third party acquirers acting in good faith are accorded protection against the security interest. The conditions for this protection, and more acutely; the definition of “good faith” vary among legal systems. The threat of protected acquisitions by third parties diminishes the value, and thereby the effectiveness of security interests. The magnitude of this threat depends on the effectiveness of value tracing mechanisms, which allow the creditor to transpose his security interest onto the value that was given in consideration for the sale, and on publicity. Value tracing tries to cure the effects of good faith acquisition protection, publicity tries to prevent it.

---

\(^4\) The same problems apply when the debtor borrows on a secured basis after having already obtained unsecured loans. Essentially, the debtor reduces the value of the prior unsecured claim by subsequently granting security interests. Adjusting to these occurrences requires the unsecured creditor to monitor and renegotiate, which is even more costly, and therefore even less likely.

\(^5\) Selling collateral doesn’t always violate those terms; in the case of floating charges on inventory, the whole idea is that the debtor sells parts of the collateral to generate revenue which can then be used to repay the loan. The floating quality of the security interest makes sure that new items of inventory that replace the ones that were sold replenish the security of the creditor.
A key concept in determining good faith is notice. Notice comes in several forms: actual notice requires that the acquirer had actual, positive knowledge of the encumbrance, constructive notice exists when the acquirer is deemed to have known about it, whether or not he actually knew. Denying protection to third party acquirers based on constructive notice amounts to imposing a duty to investigate the title of the asset on that party. The cost of such duty depends on the legal framework, and this is where the system of public notice registration of security interests comes into play. These publicity mechanisms reduce the cost to third parties of performing this due diligence, and thereby increase the scope for imposing such duty. In the end, a good publicity system can prevent a lot of good faith acquisitions and thereby reduce this threat to the proper functioning of security.

§5. Publicity mechanisms: comparative perspective

A. Introduction

The fact that an asset is encumbered in some way can be made clear in a variety of ways. Before the current reform, for example, Belgium required the debtor to relinquish possession of the collateral. If the debtor didn’t have possession of the good, no one would wrongly assume that they would be able to seize it to satisfy their claims. Obviously, this rule severely limited the scope of collateralizable assets to only those goods the debtor could do without, and therefore the availability of credit. Another unsuccessful way of publicizing the clouded title of assets, which eventually failed in Belgium, was the obligation to attach a plaque to leased machinery, notifying of the fact that it was leased.

The emerging consensus today holds that register publicity is the most effective and efficient system. The actual implementation of this principle, however, is a complicated matter. Belgium is currently reforming its personal property security system, towards a register publicity system in the style of Article 9 UCC. Comparing the two systems yields interesting results. The UCC system has a sixty-year history, and is very elaborate and detailed, while the Belgian system is brand-new and based on a concise law. The UCC therefore has answers to all kinds of questions that the Belgian system hasn’t even thought of. On the other hand, information technology has changed the world in the last few decades, but Article 9 UCC is stuck firmly in the last century, while the Belgian system is designed to maximize the benefits of modern technology.

B. An overview of the Belgian system

The new Belgian system, as laid down in the “Pledge law”, will revolve around an online, self-administered register, in which the parties to security agreements will register notices of their encumbrances. There is only one, functionally defined type of security interest, called the “pledge”. Filings will be made based on the name of the debtor, rather than linking them to the collateral, in order to avoid the need to provide unique identification criteria for all types of assets. It remains to be seen to what extent cross-sectional searching will be possible for some types of assets, such as cars which can be identified by their VIN-numbers.
Concerning the possibility for the debtor’s other creditors to protect themselves from being exploited by the security interests granted by the debtor, this will depend on the ease of access to the register for those interested parties. Unfortunately, it seems that access to the register will be severely limited for protection of privacy reasons. The exact parameters of the access to the register have not been made clear yet, but it seems pretty obvious that obtaining the benefits from publicizing security interests requires that they actually be made public.

As far as the framework on good faith acquisitions goes, the Pledge law seems, at first glance, to strike a pretty good balance. In principle, the security interest will follow an asset, regardless of transfer to a third party. This will not apply in cases where the debtor disposes of the collateral in the ordinary course of his business, such as in the case of a pledge of inventory, nor when the creditor has agreed to the particular disposition of the collateral. A third exception is the protection of possessors in good faith; if the acquirer obtains possession of the collateral in good faith, for instance through purchase or donation, then he is protected. However, this latter exception does not apply to acquirers acting in the course of their business. Professionals, therefore, are required to check the register before buying goods that are not sold in the ordinary course of the seller’s business. Under this framework, outright purchases of consumer goods, by consumers are protected. As long as the consumer takes possession of the purchased good, he doesn’t have to worry about checking the register or whether the seller really was in the business of selling this type of product. Any imposition of a duty to investigate the title of the assets on consumers would either hamper trade, or betray the consumer’s legitimate trust by imposing unreasonable burdens on him. On the other hand, of course, this protection diminishes the effectiveness of security interests. This negative effect should, however, be fairly limited because consumers are most likely to buy inventory, rather than durable means of production, and the disposition of inventory is not harmful to the creditors, on the contrary; it generates the revenue that will serve to repay them.\(^6\)

As far as professionals are concerned, however, the effectiveness of this rule again depends on the free accessibility of the register. Professionals are implicitly required to check the register before buying an asset outside the ordinary course of the seller’s business, but if they are unable to do so, they will be unable to protect themselves.

\(\text{C. Lessons the two systems can draw from each other}\)

---

\(^6\) Of course, automobiles are an obvious exception, as durable means of production for which there is a strong consumer market. As it is likely that a debtor in financial trouble might sell encumbered cars in order to raise money which can then be lost or dispersed, much of the case law and literature has bearing on this subject. Given the nature of cars, bearing unique identification numbers and requiring registration, there are many possibilities to curtail this threat with more tailored remedies.
Below are excerpts from a working paper, edited for conciseness, comparing the new Belgian system with the existing system as it exists in the US. The goal is to identify comparative weaknesses and strengths.

1. How do you describe the collateral?

A comparative note which could be helpful in the interpretation and application of the Belgian Pledge law, is the body of law developed in the US concerning the description of the collateral. While the Pledge law does refer to art. 1325-1326 Belgian Civil Code (hereafter “CC”), these articles only contain rules on the formalities to which the written agreement must adhere. The only requirement that the Pledge law imposes concerning the actual description of the collateral holds that, if the pledger is a consumer, the agreement must contain a valuation of the collateral. Obviously, the accuracy of the description of the collateral is of key importance to the parties and the proper functioning of the system. Given the summary nature of the Pledge law on this subject, one must turn to the legislative history, and to those sources on which its drafters based themselves, in order to formulate actionable guidelines for the application of this principle. Article 9 UCC is one of those sources.

Assets exist in great variety, and their use as collateral can be defined in many different ways. §9-108 UCC gives a number of examples of how, on a conceptual level, collateral can be described in a manner that meets the reasonable identification standard. Collateral can be listed specifically, by category, by type as defined in the law itself, by quantity, through a computational or allocational formula or procedure, or by any other method that allows for the identity of the collateral to be objectively determinable. Not allowed under the UCC system, however, is the so-called “supergeneric description”. Under this principle, security agreements which purport to encumber “all the debtor’s assets”, “all the debtor’s personal property” or any definition of a similarly broad nature will not be effective.

Essentially, §9-108 outlines a scale of possible ways to define collateral as a function of their generic nature, and then chooses the point beyond which the description becomes too generic and therefore no longer reasonably identifies the collateral for the purposes the system is meant to serve. The same question will have to be answered under Belgian law: how specific must the description of the collateral be to meet the requirements set out in art. 4 Pledge law?

The starting point of the scale is the least generic way of defining the encumbered assets; by specific identification. While requiring specific identification would increase the clarity of the system, it would also severely limit its flexibility. Their experience having led them to the same conclusion, the drafters of the 1972 Uniform Commercial Code
explicitly rejected this option, conveying in the official comment their intent that courts should reject pre-Code decisions which required exact and detailed descriptions. It seems fairly clear that the drafters of the Belgian Pledge law share this opinion. As a general proposition, flexibility is put forward as one of the key objectives of the system, and more specifically pertaining to the identification of collateral, the preparatory works require that the encumbered assets must be clearly identifiable, not clearly identified.

Now let’s turn first to the opposite end of the scale: the supergeneric description. This is a description using extremely broad language, such as “all the debtor’s assets”, or “all the debtor’s personal property”. The drafters of the 2001 UCC revision, following the majority of case law, explicitly rejected this type of language. Note however, that this applies only to the description of collateral in the security agreement. Supergeneric descriptions in the filing statement do not impede perfection of the security interest.

Supergeneric descriptions of collateral will most likely be rejected under Belgian law as well. In any case, it would be a stretch to claim that the Pledge law’s requirement of accurate description should include blanket pledges. Furthermore, security interests are exceptions to the fundamental principle of *paritas creditorum*, laid down in art. 7-8 Belgian Mortgage Law, and are therefore to be interpreted restrictively.

It is important to note, however, that neither US law nor Belgian law takes issue with the mere fact as such that all of a debtor’s assets are encumbered. The question is how this situation is created. If a creditor negotiates a multitude of security interests which, cumulatively, cover all of the debtor’s assets as a factual matter, but each one of them covers reasonably identifiable assets, then these security interests will remain valid. If, however, a creditor takes out a single security interest which purports to cover “all of the debtor’s assets”, then this description will not meet the necessary standards.

For example, debtor D is a company, which owns two cars and a lawn mower, and nothing else. On its passive, D owes a € 20,000 tort liability debt. Creditor C lends the € 20,000 to D with which D can discharge the debt, and takes a security interest in “the two cars with VIN #XXX and #XXY, as well as the lawnmower with serial number XYX”. Practically speaking, this security interest encumbers all of D’s assets, but because the description is not supergeneric, it will be valid. If, however, the security agreement covered “all of D’s personal property”, this description would be deemed too broad, even though the assets effectively covered are the same.

Even though supergeneric and sufficiently specific descriptions of collateral might turn out to be factually identical in some cases, conceptually they are not. Supergeneric security interests are open-ended in two dimensions. Firstly, they will float along with any increase in assets within certain categories of goods. Giving this quality to a security interest is, as a principle, allowed. Security interests can cover categories of goods, including after-acquired property. Secondly, however, a supergeneric description also floats along with any new categories of goods added to the debtor’s estate, and this is deemed excessive.
For example: a security interest covering “all present and future motor vehicles in the debtor’s possession” is open-ended within the category of motor vehicles. If the debtor acquires additional vehicles, then the collateral will increase. A security interest covering “all the debtor’s personal property”, however, is open-ended across categories. If the debtor owned only motor vehicles at the time the security interest is granted, but subsequently acquires computers, machinery and a rare book collection, then all these additions would also be added to the collateral, to the detriment of other creditors.

The requirements on the definition of collateral subject to Belgian pledges will therefore be positioned somewhere on the scale between specific and supergeneric. While the exact determination will necessarily need to be left to the Belgian courts, US law and doctrine can be helpful in providing some guidelines.

- Safe harbor descriptions: §9-108 UCC gives parties the option to simply describe the collateral using the definitions offered by the UCC, in which case the sufficiency of the description is secured. The development of similar unequivocal concepts, through legislation, case law or doctrine, would also usefully increase legal certainty in the Belgian application. A similar effort has taken place since 1919, when the floating charge on a business was enacted into law, without defining exactly what that concept of business entailed. Subsequent case law and doctrine has developed and refined this concept, although its fleeting nature has made it impossible to come to a single definition. Similar efforts, pertaining to simpler concepts such as “equipment”, or “inventory”, could prove quite useful in the application of the Pledge law.

- §9-108(b)(6) UCC closes the safe harbor descriptions with a catch-all provision, which allows for any other method, as long as it allows for objective determination of the identity of the collateral. The requirement of an objective determination indicates that this cannot be left to the subjective determination by the parties, which would, under Belgian law, be an illegitimate potestative provision.

- After-acquired collateral: as discussed above, after-acquired collateral can be brought under the coverage of a US security interest or a Belgian pledge. The question at issue here, is what kind of language is required to achieve this extension of the collateral. This is a matter of contract interpretation, and most courts have held that some language specifically referring to after-acquired collateral (e.g.: “now owned or later owned”) coverage is required, unless the collateral is inventory or accounts, in which case the line is less clear, or trade custom or normal business practice would dictate such inclusion. Given Belgian law’s experience with the pledge of the business and the principle of in rem subrogation, a pledge entailing inventory will likely be interpreted as automatically including after-acquired inventory.

- Parties’ course of dealing: in the absence of ambiguity, US courts are reluctant to look at the parties’ course of dealing to interpret the language of the security agreement. This kind of caution does indeed appear warranted, especially given the fact that the legitimacy of the priority granted to security interests is founded on publicity, which only covers written instruments.
2. When is the debtor in default on the secured obligation?

Obviously, default by the debtor in some form is the natural starting point of any kind of enforcement, and US law can be highly instructive in the interpretation of this concept. The Pledge law simply mentions non-payment and insufficiency, without any further explanation. However, Belgian law pertaining to execution has traditionally used the concept of exigibility (“opeisbaarheid/exigibilité”) as a precondition for access to measures of forced execution. Pursuant to art. 1188 CC, obligations which are meant to be met over time, such as loans, lose this benefit of postponed fulfillment when the debtor goes bankrupt, or when the debtor has reduced the security he granted his creditors. In these cases, the obligation becomes immediately exigible.

The UCC doesn’t provide any definition of default at all, leaving the parties free to negotiate and agree upon the circumstances that will be deemed to constitute a default. This freedom accorded to the parties in the US comports well with the freedom of contract, which also underlies the Belgian reform, as well as with the reality of secured finance, in which the underlying obligations and dynamics are often more complicated than a simple obligation to pay at a given time. US secured lending practice has evolved towards rather elaborate clauses outlining the events of default, which are designed to include any events which might upset the balance of the contract. For instance, clauses defining the events of default will often include any events which give rise to the acceleration of debts owed by the debtor to other creditors. This is known as a “cross-default provision”. The acceleration of debts owed to others is often a sign of distress, in which case the secured creditor wants to have the option to pull out of the loan as quickly and safely as possible, by calling a default and foreclosing on the collateral. While such contractual freedom could prove quite useful in the Belgian context, it is unlikely that the parties will be able to push it as far as the “general insecurity clause”, which is common practice in the US. This type of clause usually reads something to the effect that the events of default will also include “any other change in the condition or affairs, financial or otherwise, of the Debtor or any guarantor or surety of the liability secured by this agreement which in the opinion of the Secured Party impairs the value of the collateral or imperils the prospect of the Debtor’s full performance or satisfaction of its obligations secured by this agreement”. This clause obviously gives very broad discretionary power to the secured creditor, however, that discretion is curtailed by the general obligation of good faith. Under Belgian law, such a clause will likely be struck down as being potestative; giving one of the parties a unilateral right to determine whether or not the contract will be carried out any further. In order to steer clear of the prohibition on potestative conditions, the creditor could formulate a wide default provision as a clause concerning the exigibility of the debtor’s obligation, based on art. 1188 CC. This article allows creditors to demand immediate performance when the debtor has taken actions that reduce the security he had granted by contract. Such a clause based on art. 1188 CC could not, however, be stretched to a general insecurity clause, as it can only be triggered by actions taken by the debtor, and not by external factors.
3. After repossession of the collateral, how is it turned into monetary value?

The UCC uses the abstract term “disposition”, while the Pledge law specifically mentions the selling or leasing of the collateral. Based on the legislative history of the Pledge law, which emphasizes first and foremost that the disposition be performed in an economically responsible manner in order to maximize the proceeds, it stands to reason that the terms sale and lease should be interpreted as an enumeration referring to the broader concept of disposition.

When it comes to the practicalities of disposing of the collateral, however, the two systems diverge. US law gives the creditor almost unlimited practical freedom in setting up the sale or lease transaction, which can be both public or private, take place online or in person, in whichever type of venue the creditor deems fit. Belgian law, however, requires the interposition of the Belgian equivalent of the sheriff, the “gerechtsdeurwaarder/huissier de justice”, who can then decide on the modalities of disposition. In both jurisdictions, the secured creditor is allowed to acquire the collateral at a public disposition. At a private disposition, however, Belgian law does not allow the secured creditor to be the purchaser, while US law allows this only if the collateral is of a kind usually sold in a recognized market, or the subject of widely distributed standard price quotations.

While selling or leasing the collateral is a pretty straightforward way of disposing of it, appropriation of the collateral by the secured creditor is much more controversial, and therefore framed with much more restrictive rules. Both jurisdictions allow for the principle of execution through appropriation by the secured creditor, and both require the consent of the debtor. In the modalities of this consent, however, the two systems diverge. In order for the secured creditor to appropriate the collateral under Belgian law, the required consent of the pledger can be obtained before execution is pursued, as early as the time of the pledge agreement itself. This possibility of ex ante agreement to appropriation of the collateral by the secured creditor is one of the major innovations of the Pledge law. If such agreement is made in tempore non suspecto, it must hold that the value of the collateral will be determined at the time of appropriation by an expert and, when dealing with goods which are sold in a market, based on their market value. Under the UCC, however, the debtor can only consent to the acceptance of collateral in full or partial satisfaction of the debt after default. The debtor must consent in an authenticated record, or, in case the collateral will be accepted in full satisfaction of the debt, can be derived from a proposal to that effect sent by the secured party to the debtor, which is unconditional or subject only to the condition that the collateral be preserved or maintained, which proposes to accept the collateral in full satisfaction of the secured debt, and goes unanswered for twenty days. This proposal must be made in the form of an authenticated record.

The debtor is not the only party who must consent to the acceptance of the collateral in lieu of payment of the debt; the secured creditor has to agree to this as well. Since the debtor is liable for any deficiency after disposition of the collateral, as will be discussed below, it would be in his interest if the creditor would accept the collateral in full
satisfaction of a debt that is actually much higher than the value of the collateral. A debtor could therefore turn over possession of the collateral to the creditor and then argue that the latter’s acceptance of possession of the collateral amounted to acceptance of the collateral in full satisfaction of the debt. In order to eradicate any doubt about the possibility of such constructive acceptance, §9-620(b) UCC requires the secured party to either consent in an authenticated record, or express his consent indirectly by sending a proposal, which also requires an authenticated record, to the debtor. The Pledge law does not contain any specific rules on how to deal with this kind of constructive acceptance, leaving the question of whether the secured creditor’s consent can be derived from his silence and other factual circumstances to the general law of obligations.

If the creditor does in fact accept the collateral in lieu of payment, he will become the owner of the collateral in both jurisdictions. The Pledge law, however, is rather brief on the consequences of such appropriation. Again, comparison with the UCC is quite instructive, as it presents an explicit framework for these questions. Pursuant to §9-622 UCC, the secured party’s acceptance of the collateral discharges the obligation to the extent consented to by the debtor, transfers to the secured party all of the debtor’s rights in the collateral, and discharges the security interest held by the secured party. The same result follows from art. 53 of the Pledge law and the adage nemo plus iuris transferre potest quam ipse habet. In addition, acceptance of the collateral in satisfaction of the debt also discharges any subordinate security interests or liens held by others. This is a question of priority and enforcement of security interests against third parties.

Foreclosure upon collateral will result in two possible kinds of proceeds. If the collateral is disposed of, the proceeds are monetary in nature. If the collateral is accepted in full or partial satisfaction of the secured claim, the proceeds consist of the full or partial discharge of the secured obligation. The amount of this discharge will depend on the negotiations between the debtor and the creditor. In both jurisdictions, monetary proceeds are applied first to the expenses of execution, the definition of which varies between the two jurisdictions. Next comes the secured obligation itself (or multiple ones, in their respective order of priority). After the relevant creditors have been paid out of the proceeds, any surplus will accrue to the debtor, while any deficiency will, in principle, be added to the debtor’s liability.

Therefore, the amount of money the collateral brings in is of key importance to the parties. Usually, however, foreclosure upon collateral through disposition will result in a deficiency. Forced sales of assets are usually not the best way to get a good price. In addition, if the collateral is in fact worth significantly more than the outstanding debt, the debtor would usually not let the situation get to the point of repossession and forced sale. A partial solution to this problem is offered through the right to redeem the collateral, which allows a debtor to buy off the forced disposition of the collateral by satisfying the obligation secured by it in full. If the collateral is worth more than the secured claim, but is likely to bring in less than that claim in a forced disposition, it is in the debtor’s interest to redeem, in which case the forced disposition will not take place. If, however, the remaining value of the collateral is less than the outstanding secured amount, it is less likely to be in the debtor’s interest to redeem.
The cost and effectiveness of the methods used in the disposition of the collateral in terms of the revenue they bring in, is therefore of key importance to the debtor, as any cost-ineffective methods will either reduce the surplus or increase the deficiency. In both jurisdictions and regardless of the means of foreclosure, therefore, such foreclosure must be carried out in good faith and in an economically responsible or commercially reasonable manner, on pain of liability of the secured party, which cannot be limited through ex ante agreement. Under the Pledge law, this requirement means that if the collateral is traded in a recognized market or exchange, the foreclosure sale will take place in that market or exchange.

If the debtor is of the opinion that the methods used are not commercially reasonable or economically responsible, both jurisdictions allow him or her to turn to the courts for relief. Such action can be brought both during the foreclosure procedure, before the disposition has actually occurred in order to seek an injunction to adopt different methods, and afterwards, seeking damages.

To limit the risk of disagreement and the consequent cost of litigation, both systems allow the parties to agree on the methods to be used in the foreclosure on the pledged assets, as long as the secured party acts in an economically reasonable manner or the standards agreed to are not manifestly unreasonable.

If, on the other hand, the pledger is a consumer, the liberal self-help regime outlined above is restricted in both jurisdictions, through mandatory rules which cannot be circumvented through contract.

As stated above, US law allows the parties rather broad freedom to define the events which will give rise to a default under the agreement, a freedom which might, to a limited extent, be both useful and valid under Belgian law. When dealing with consumers, however, many states have adopted consumer protection laws that disallow a secured party from acting on certain types of events of default, even if the consumer has agreed to the terms, unless that event puts the secured creditor’s chances of repayment at a defined state of heightened jeopardy. Similarly, Belgian law has adopted specific limitations on the execution rights of creditors against consumers.

In both jurisdictions, the process for repossession against consumers is functionally similar to that against non-consumers. In Belgium, repossession must be performed by the sheriff (gerechtsdeurwaarder/huissier de justice), whereas US creditors can obtain a writ of replevin or resort to self-help repossession. From then on, however, the Pledge law imposes judicial review of the entire execution process against consumers. Any form of disposition of the collateral requires the intervention of a judge. Regardless of whether a sale or lease of the collateral will be held publicly or privately, a court ruling is required, and as with non-consumers, the creditor is not allowed to purchase the collateral at a private sale. In the UCC system, the creditor still has relatively broad freedom to organize the disposition, but will have to comply
with stricter procedural requirements, and enjoys more limited possibilities for appropriation of the collateral.

Appropriation of the collateral given by a consumer is, as a principle, possible in both jurisdictions, albeit under more stringent conditions. As mentioned above, the Pledge law requires judicial overview for the entire execution process against consumers, and that includes appropriation of the collateral. For purposes of applying the putative proceeds of the collateral to the outstanding debt, the appropriated collateral must be valued by a court-appointed expert. The objectivity of such valuation is highly important, as it will determine whether the debtor will be liable for any balance, or on the contrary will receive a surplus. The UCC on the other hand, does not allow acceptance of collateral in partial satisfaction of the obligation in consumer transactions, rendering any attempted acceptance in partial satisfaction void. This provision is linked to the mandatory disposition of consumer good collateral of which 60 percent has already been paid off. In addition to these protections, there are many rules which limit the recovery of deficiency balances against consumers.

4. How is a security interest made generally enforceable against third parties?

In both jurisdictions, there are several different ways in which a security interest can be perfected or made generally enforceable. The primary mechanism of interest is the publication of the security interest by “filing” or “registering” it in a form of database which can be searched by third parties. Secondly, the secured creditor can take possession of corporeal movable collateral in order to publicize his interest and make it generally enforceable. Thirdly, with respect to intangible assets consisting of claims and various kinds of investment property, the taking of control over these assets will serve the same purpose. Finally, purchase money security interests will often be perfected, or made generally enforceable automatically, without any further action by the parties.

5. Centralized set-up of publicity is beneficial

The primary means of obtaining erga omnes enforceability, is by way of registration in a register or filing system which is, at least to some extent, publicly accessible. This type of “perfection” is the most prominent one, and the most interesting from a comparative perspective.

In the implementation of the Pledge law, the Belgian executive is currently setting up the National Pledge Register. This register will be an online database, in which parties will be able to enter information regarding the pledges they have agreed to. On the output side, third parties will be able to search this register in order to find information on granted pledges.

The largest advantage of the Belgian system, as compared with the UCC filing system, is its centralized and modern nature. The UCC is a model law, adopted and implemented by the individual states, resulting in as many as 4300 offices and registries that handle art. 9 filings, each of which has different procedures, fees, customs, search logics and locations.
As a consequence, a secondary economy has arisen in the form of filing and search companies, who have gone through the learning curve in the filing offices they cover, and offer these services for a fee. Because there are many locations where a filing can be done, the UCC systems also need rules to determine where exactly any given security interest should be filed in order to be effective. These rules, however, are often ambiguous. A prudent creditor will therefore often decide to file in multiple places. Consequently, a prudent searcher will search in multiple places. Moreover, the ambiguity does not end there. Sometimes, debtor names can also be unclear, or might change. And finally, debtors can move from one jurisdiction to another. Therefore, even though the direct fees for filing and searching are rather low, the combination of all these factors results in significant transaction costs for the users of the system.

The Belgian system, on the other hand, is centralized in a single, online system, bypassing any need to file in multiple places because of ambiguity concerning the location of the debtor or the collateral. Furthermore, the single system will have a single search logic, allowing the searchers to optimize the need for multiple searches due to possible name changes and other ambiguities. Finally, the simplicity of the system and the fact that it is accessible online preempts the need to outsource searching and filing.

6. Accuracy of filings

In both jurisdictions, registration of the pledge is left to the secured party, who is, after all, the party with the strongest interest in doing so. Obviously, leaving this task to the secured party entails a risk of malfeasance. The Pledge law counters this risk with the explicit imposition of liability for any damages resulting from entry of incorrect data into the register. The pledgeholder is furthermore required to inform the pledger in writing of the registration, which in turn explicitly confirms the aforementioned liability. While the security agreement, in the inter partes dimension, does not require written form if there are no consumers involved, registration does require a written security agreement. The UCC requires that the secured party be authorized by the debtor to file the financing statement, in an authenticated record. This authorization, however, is an automatic consequence of the debtor’s entering into the security agreement.

The risk of malfeasance is not an imaginary one, as US experience shows. By falsely creating the impression that many of a debtor’s assets are encumbered, malignant actors might extract considerable nuisance value, and have done so in the past. Such unauthorized filing statement would be ineffective under §9-509(a) UCC, and the falsely named debtor has the right to file an information statement denouncing the false filing. However, neither of these provisions really matter, as the doubts cast over the unencumbered status of the assets, cast by the fraudulent filing, will not be lifted in the mind of the searching prospective lender. This has prompted some US states to pass legislation making such fraudulent filings criminal offenses. The Belgian system has a simpler solution for this problem. If the pledgeholder fails to rectify the incorrect information contained in the register, the pledger can demand removal or modification, if necessary with the government agency which operates the register. This agency will, after seeking the advice of the pledgeholder, verify the entry.
This problem of false filings is further compounded under US law by the fact that a financing statement may be filed before the underlying security interest even attaches. In that case, perfection of the security interest does no coincide with registration, as perfection presupposes attachment. This rule is meant to provide flexibility and certainty to practitioners, who can use it to close any gap between authentication of the security agreement and filing of the financing statement, by simply filing first. However, it also further tilts the balance of power in favor of creditors and increases the potential for frivolous filings.

A falsely named debtor can of course sue the false filer, in both the US and Belgium, for damages and release of the falsely created security interest. If, however, the filer is judgment proof, such suit will still be to no avail. The question then becomes whether a better solution might be designed or emerge automatically. Given the lending landscape in Belgium, in which borrowing predominantly occurs through banks and other regulated financial institutions, these institutions might become gatekeepers to the system. Given the threat of damaging false filings, as well as the privacy considerations outlined above, it is entirely possible that the executive will limit access to the system to banks and other institutions which are subject to heavy regulation. Alternatively, these players might even emerge as automatic gatekeepers. Since they will rely the most on the system, they have every interest in verifying and enforcing the accuracy of the system.

A similar issue arises when one considers the possibility that the debtor’s identity might be misrepresented in the register, whether intentionally or as a consequence of mistake. Obviously, both jurisdictions require that the filed information contain the identity of both the secured party and the debtor. Both jurisdictions also have similar rules for dealing with minor errors and omissions which nevertheless allow searchers to obtain the correct information through the system’s search logic. From this point onwards, however, the UCC provides a more elaborate set of rules to determine when a person’s identity is sufficiently well-defined, in §9-503 UCC. In the exact implementation of these rules, States are given the freedom to choose between alternatives, enacting those rules which best match their systems of personal identification. Essentially, §9-503 provides a number of safe harbors, rendering sufficient for example the nomination of a registered organization through the name that is stated to be that organization’s name on the public organic record most recently filed with or issued or enacted by the relevant jurisdiction. For individuals, connection is sought where possible with the name indicated on the driver’s license, which is the typical instrument of identification in the US. If no such safe harbor provision can be used, individuals are to be designated by the name by which they are generally known, for non-fraudulent purposes, in the community. The individual’s birth certificate will not be determinative of this name, people can adopt a simplification of their birth name, or even change their name without taking any legal action. Again, Belgium could, in the implementation and application of the Pledge law take its cue from the US and improve on the solutions offered there, thanks to the simpler context. Individuals in Belgium are all given ID cards at the age of twelve, which, in addition to their official names, contains a unique identification number. Similarly, corporations which are active in Belgium are required to have an identification number, issued by the Central Registry for Enterprises (“Kruispuntbank voor Ondernemingen”).
At the very least, using these regulated forms of identification would be basic due diligence, and it is quite likely that the eventual design of the system will require this information to make a valid entry.

Upon fulfillment of the debt, the security interest and its public notice have served their purpose, and in order to clear the title to the collateral, the public record is to be made to reflect that situation. The Pledge law orders the pledgeholder to remove the registration of the pledge. In case of disagreement, the pledger can turn to the courts to request an order that the registration be removed, as well as damages. The UCC imposes the same affirmative duty to clear the record when the security interest is in consumer goods. Unlike the Pledge law, the UCC gives this provision teeth by imposing a one month deadline, which is shortened to 20 days if the debtor actually demands such termination. When the security interest rests on collateral other than consumer goods, there is no affirmative duty to clear the record on the part of the secured party, since most filing statements will expire after five years anyway. The secured party will in this case only be required to file a termination statement after receipt of an authenticated demand to do so by the debtor, subject to the same 20 day deadline.

7. Mobility of assets and protection of purchasers in good faith

The functional structure of a bona fide purchase which supersedes erga omnes enforceability of security interests is the following: a third party to the security agreement, who neither knows of the security interest nor is deemed or required to know of it, purchases the collateral, which is a violation of the security interest. In principle, the secured creditor is able to enforce his security interest against this third party, but under certain circumstances, he will not be able to do so. In the trade-off between the rights of the secured creditor and those of a third party acting in good faith, the law will sometimes favor the third party.

Plainly, this construct does not come into play in those circumstances where the debtor is allowed, and often even supposed, to dispose of certain types of collateral free of the security interest that encumbers them. The textbook example of such a case is a floating lien on inventory: the secured creditor not only allows the debtor to sell that inventory, he wants him to do so, in order to generate revenue to repay the loan.

This example leads us to the first important construct in understanding bona fide purchases: the ordinary course of business exception. The fact that the sale of goods by the debtor happens in the ordinary course of his business has certain legal consequences.

Under the Pledge law, the default rule is that the pledger is allowed to dispose of the collateral in the ordinary course of his business, without the need for any specific provision in the security agreement allowing him to do so. Of course, the parties are free to modulate or exclude this right. Aside from the implied consent of the secured party to the disposition of the collateral, which is derived from the lack of modification of the default rule, the secured party can of course also consent to any specific disposition of the collateral by the debtor. It is quite trivial that in such a case, the security interest will not be enforceable against the purchaser either, in both jurisdictions. Consent by the secured
party to the disposition free and clear of the security interest can, under US law, be given expressly, or can be implied from the parties’ course of dealing. For instance, when the secured creditor knows of the regular disposition of collateral by the debtor and never objects to it, many courts will assume the former’s consent.

More important in US law than specific authorization, however, is the ordinary course of business exception. This exception allows third parties to acquire the collateral from the debtor, free and clear of the security interest, if the sale of the collateral occurred in the ordinary course of the seller’s business. It is indeed important to note that, perhaps ironically, the “buyer in the ordinary course of business exception” pertains to sales in the ordinary course of the seller’s business.

At first sight, US law appears not to impose a good faith requirement in the application of this exception; regardless of whether the purchaser knew of the security interest, and regardless of whether that interest was perfected, he will be able to take the collateral free and clear. However, the definition of “buyer in ordinary course of business” is limited to those buyers who do not know that the sale to them violates the rights of others in the goods. Therefore, good faith is in fact required of the buyer with regard to the particular sale at hand. For instance, a buyer may know that the store where she buys a widget is financed under a security agreement which entails a blanket security interest on inventory. However, this kind of security agreement almost invariably authorizes the debtor to sell the inventory free and clear. All §9-320(a) UCC does, is allow the buyer to assume that this is the case for her particular seller. If, however, the buyer knows specifically that her purchase would violate the particular security agreement that covers the widget, she will not be entitled to protection as a purchaser in ordinary course of business. In addition to good faith, the definition of ordinary course purchaser requires that the purchaser take possession of the goods, or have a right to recover the goods under Art. 2.

The Pledge law contains an arrangement that is functionally highly similar. As mentioned above, third parties can assume that the sale of goods in the ordinary course of the debtor’s business is authorized. Even when this is not the case, either because the sale was in fact not authorized regardless of its ordinary course of business nature, or because the sale did not fall within the scope of the ordinary course of the debtor’s business at all, the purchaser can enjoy protection if he acted in good faith. As long as the purchaser takes possession of the goods, and acts in good faith, he will still take the goods free and clear. However, under the Pledge law, registration will put professional purchasers on constructive notice of the security interest, destroying their good faith, thereby denying them the benefit of the bona fide purchase. Consumers, therefore, are not required to search the register, whether or not the sale occurs in the ordinary course of the business of the seller.

As the above makes clear, security interests can be extinguished by certain purchases by third parties acting in good faith. This does not necessarily mean, however, that the secured creditor loses all protection. Firstly, both jurisdictions allow the secured party to trace the value given by the third party purchaser in the hands of the debtor, albeit to a
different extent. Under the UCC, the security interest will automatically attach to the proceeds of the disposition. Furthermore, that security interest will also remain perfected in the proceeds, if the security interest in the original collateral was perfected, for a grace period of 20 days. On the 21st day, this perfection will lapse, unless the initial filing statement can put third parties on notice, the proceeds are identifiable cash proceeds, or the security interest in the proceeds is itself perfected within the 20-day grace period. Belgian law allows for a similar concept of value tracing, but its extent is more limited. The Pledge law explicitly confirms the operation of the principle of in rem subrogation, extending the pledge to the debt claims that replace the collateral in the debtor’s estate. The proceeds which can be traced are therefore, in the traditional view, limited to the initial debt claim. As soon as this claim is paid, and replaced by cash which is commingled in the estate of the debtor, the pledge is extinguished. Some scholars, however, would argue otherwise, and it remains to be seen to what extent case law will follow either position. The parties can, however, cover this contingency through the terms of the security agreement, by defining the object of the pledge in such a way as to create a floating pledge.

Secondly, the unauthorized disposition of collateral to the detriment of the secured creditors can subject the debtor to criminal sanctions. Some US states have passed legislation which makes the sale of collateral without authorization and without promptly remitting the proceeds to the secured creditor a criminal offense. The Pledge law also imposes criminal penalties on any fraudulent disposition or relocation of the collateral. In addition and more generally, the Belgian criminal code outlaws the fraudulent effectuation of one’s insolvency, under which description this kind of transaction can be brought.

8. Mobility of assets: flexibility to put them highest-valued use

Traditionally, Belgian property law requires that in rem rights, of which pledges are an example, conform to the specialty principle. According to this principle, in rem rights can only have bearing on specific objects, determined and identified *ut singuli*, as opposed to obligatory rights which pertain to a certain value, without this connection to specific goods in which the value may be stored. The consequence of the application of this principle for in rem security interests was that they were lost upon commingling or incorporation into other movable or immovable goods of the collateral, as they were no longer individually identifiable.

In order to increase the practical scope of assets against which can be borrowed, the Pledge law has relaxed this principle along three conceptual lines.

The first such relaxation pertains to the incorporation of the collateral into another movable, which I will call “processing”. Art. 18 of the Pledge law allows the pledger, who remains in the possession of the collateral, to process the collateral unless the parties have agreed otherwise. If this processing results in a new good, then under old law, the pledge would be lost, for lack of compliance with the specialty principle. Under the Pledge law, however, the pledge will encumber this newly created good, unless the parties have agreed otherwise. If this processing also entailed the use of other goods...
which belonged to third parties, and which can no longer be separated as a practical or economic matter, then the pledge will still encumber the newly created good, if the initial collateral was the primary good. The third party to whom the other parts belonged will then have an obligatory claim for unjust enrichment.

The second strand of relaxation of the specialty principle relaxes the consequences of commingling of the collateral, in the Belgian sense. Under the Pledge law, if the collateral is commingled, the pledge simply encumbers any goods in the pool which meet the description of the collateral. The pledge therefore no longer has to maintain its connection to the exact, specific goods in which it was initially granted.

US law employs mechanisms similar to these, be it along slightly different conceptual lines. The concept of processing in Belgian law is similar to that of accession in the UCC, but moves beyond that and partially into what US law calls “commingling”. Accession is defined as goods that are physically united with other goods in such a manner that the identity of the original goods is not lost. If the identity of the original good is lost, then the goods are “commingled” in the American sense. This concept differs slightly, however, from the Belgian concept of commingling, as it goes beyond the mere bringing together of goods of the same general characteristics so that the original one is no longer identifiable, i.e. the Belgian form of commingling, and includes some instances of what under Belgian law would be processing.

Priority in accessions is governed by §9-335 UCC. A security interest which had been perfected before the collateral became an accession, remains perfected in the collateral. Except for certificate-of-title collateral, the normal priority rules apply. If the collateral is an accession to a good in which a security interest is perfected by compliance with a certificate-of-title statute, this latter security interest will have priority over the one in the accession. Furthermore, the secured party who has priority over all other claimants in the whole has the right to remove the accession which is his collateral, upon default of the debtor. If, over the course of this removal, the whole or the other goods suffer damage, the removing creditor will have to reimburse this damage.

If, on the other hand, the goods which are brought together do lose their identity, they are commingled under US law. A security interest does not exist in commingled goods as such, however it may attach to the product or mass created by the commingling. If a security interest was perfected in the goods before commingling, it remains perfected in the product or mass. If this is the case for multiple security interests, they rank equally according to the ratio that the cost of the goods to which each interest originally attached bears to the cost of the total product or mass.

The third and last digression from the specialty principle by the Pledge law is connected to the incorporation of the collateral into an immovable asset, and was discussed above. Where the secured creditor would, under old law, be relegated to a general unsecured creditor, the Pledge law accords him priority in the proceeds of the real estate in which his collateral was incorporated. The UCC, on the other hand, requires that the secured creditor do a separate fixture filing in the relevant office in order to maintain perfection.
While these relaxations brought about by the Pledge law are obviously inspired by the will to accommodate commercial practices, one could argue that they do so at the expense of the coherence of the system of in rem rights.

§6. Conclusion

Secured finance is complicated, and the policy dimension is no exception. The underlying economic dynamics of lending can help answer some important questions: why do we have security interests, who stands to win from using them and at whose expense, how can a party protect itself against exploitation,…? Thinking about the policy behind the system is the quickest and most accurate way to get a complete view of that system, and to understand it better as a practitioner. The end result to a practitioner and his clients will be a function of economic reality combined with the tweaks to that reality provided by policy. Policy is designed based on, and operates within that economic reality. A practitioner who wants to maximize his results therefore cannot be content knowing what the law is, without understanding why it is so.

The real trick here is to combine the broad helicopter view of economics with the detailed nature of the law. Economics can give us strong, analytic processes which lead to sweeping results. These results, however, are built on highly stylized models and theories, that ignore most of reality because it creates too much noise. Law, on the other hand, is hyperdetailed and therefore ready for most challenged reality throws at it, but lacks in analytical rigor. By combining both dimensions, a well-trained practitioner can use the broad directions given by economics, and implement them down to the last detail so that they will actually work in the real world, to end up with stronger results.
§7. Reading list


A. Morell, F. Helsen, “The interrelation of transparency and availability of collateral: German and Belgian laws of non-possessory security interests”, *European Review of Private Law* 2014, afl. 3, 393-438


