Part 1

The Conceptual and Legal Framework

The Law and Economics Debate About Secured Lending: Lessons For European Lawmaking?

by

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I. Introduction

The desirability of secured lending was extensively debated in the early law and economics literature. On the one hand, it was argued that secured credit helped to mitigate problems flowing from information asymmetries in credit markets, and thereby facilitated the provision of debt finance to borrowers. Others, however, took a less benign view of the institution of secured credit, arguing that it could facilitate the redistribution of wealth away from those

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unable to adjust the terms on which they advanced credit. This would be undesirable not only on distributional grounds, but on efficiency grounds as well: deadweight costs would be incurred by the excessive grant of secured credit in order to bring about such redistribution.

This literature has, in the eyes of many legal scholars and practitioners, lacked persuasive force because of its apparent divorce from reality. This criticism was famously articulated by Homer Kripke, who wrote in 1985 that contributions to the law and economics literature were, "notable for their use entirely of examples with assumed facts … and for the absence of any attempt to determine whether these factual assumptions are typical of real world events".[1] This type of criticism became a slogan under which many dismissed economic analysis as irrelevant to legal scholarship. However, in the interim, law and economics scholars have heeded Kripke's call for more empirical research.[2] A growing empirical literature now exists on the use of secured credit, and the impact of changing laws that facilitate it. This paper reviews the empirical literature and argues that the findings tend to suggest that secured credit is, on the whole, socially beneficial, and that such benefits are highly likely to outweigh the social costs of any transactions motivated by redistribution.

Having made this general claim, this essay then turns to consider the effects of four particular dimensions across which systems of secured credit may differ, and which may therefore be of interest to European law-makers. These are: (i) the scope of permissible collateral; (ii) the efficacy of enforcement; (iii) the priority treatment of secured creditors; and (iv) the mechanisms employed to assist third parties in discovering that security has been granted. In each case, we will consider first the theoretical position, and then discuss empirical findings. In conclusion, it is argued that perhaps the most difficult of these issues for European law-makers concerns the appropriate design of publicity mechanisms for third parties.

II. General theories of secured credit

1. What does secured credit do?

The grant of a security interest may be understood from a functional perspective as conferring upon the lender two sets of entitlements, which relate respectively to *priority* of payment and to *control* of the collateral.[3] The control rights are what economists call "state contingent", because their extent is contingent on

1 H Kripke, 'Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact' (1985) 133 University of Pennsylvania Law Review 929, 961.
2 *Ibid*, 984.
3 See generally, RM Goode, *Legal Problems of Credit and Security* (3rd ed, 2003), 1–3.

whether the debtor continues to meet their obligations under the loan.[4] Provided the debtor is not in default, the secured creditor's control is of a purely negative variety, consisting of the ability to veto sales of the collateral. If the debtor is in default, then the secured creditor has a positive right (subject to any procedural restrictions imposed by insolvency law)[5] to control the liquidation of the collateral. Moreover, the secured creditor is entitled to priority of repayment out of the proceeds of sale of the collateral.

From the point of view of the secured creditor, a grant of security lowers default risk. All other things being equal, a creditor may therefore be expected to offer a debtor more advantageous terms – for example, a reduced interest rate – when lending on a secured rather than an unsecured basis. However, the priority accorded to a secured creditor means that unsecured creditors will now fare worse in insolvency. They may therefore be expected to demand terms that are correspondingly less advantageous for the debtor – for example, an increased interest rate. From the debtor's point of view, these adjustments in borrowing terms might be expected, in markets in which creditors adjust perfectly to the risks they undertake, to cancel each other out.[6] Moreover, a grant of secured credit creates costs for the debtor – in terms of restrictions over alienation of assets – that are not present in an unsecured borrowing arrangement. The early literature on secured credit viewed these stylised facts as giving rise to a "puzzle" over why debtors grant security: if the effect of security on a debtor's aggregate cost of capital is neutral (secured creditors reduce rates, unsecured creditors increase them), and there are costs to the debtor associated with a grant of security, why bother?[7]

Various theories were advanced to explain why debtors might nevertheless be motivated to offer security to their creditors. These fall into two broad categories. "Efficiency" theories of secured credit suggest that its use generates benefits not present in an all-unsecured capital structure, such that the total cost of credit goes down. "Redistributive" theories, on the other hand, suggest that a reduced overall cost of credit is obtained at the expense of creditors who do not adjust their terms to reflect the fact that a grant of security has reduced the expected value of their claims. We will now briefly review each of these theories.

4 On the terminology, see, eg, A Kalay and JF Zender, 'Bankruptcy, Warrants, and State-Contingent Changes in the Ownership of Control' (1997) 6 Journal of Financial Intermediation 347, 349.

5 Such as the moratorium imposed by UK law on the enforcement of security in administration proceedings: Insolvency Act 1986 Sch B1, para 43.

6 TH Jackson and AT Kronman, 'Secured Financing and Priorities Among Creditors' (1979) 88 Yale Law Journal 1143, 1148.

7 See A Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories' (1981) 10 Journal of Legal Studies 1.

2. Security and signalling

Two principal theories – with diametrically opposed empirical predictions – were advanced to suggest that security interests could enhance efficiency in credit markets characterised by asymmetric information.[8] The first, the "signalling" theory, viewed security as a "hostage" offered by a debtor to a creditor to demonstrate the seriousness of the debtor's commitment to repayment.[9] If security is something that would be more costly for a "low-quality" borrower to offer than a "high-quality" borrower, then willingness to offer it can be a credible signal of quality. In a market characterised by asymmetric information, the ability to use a signal can assist creditors in reducing their costs of screening potential borrowers. The prediction of the signalling theory is therefore that more creditworthy borrowers will be more willing to offer security. This is, however, contrary to available empirical evidence on the use of security, which finds that it tends to be granted more frequently by younger, and smaller firms – both known proxies for lower creditworthiness.[10]

The problem with the application of signalling theory to secured credit lies in a simplistic interpretation of the cost of granting security. It is assumed that a grant of security is costly for a debtor, because the debtor runs the risk of losing the collateral, and that this cost is greater (in expected value terms) for a less creditworthy debtor, because the risk of losing the collateral is greater. But from the debtor's point of view, there is no difference in the consequences of default as between secured and unsecured borrowing: *in either case*, the debtor's assets will be seized by creditors. The benefit of being a secured creditor under such circumstances is not vis-à-vis the debtor, but against other creditors – the secured creditor has priority as regards repayment. The difference between secured and unsecured borrowing, as perceived by the debtor, will rather be felt in states of the world in which default does *not* occur. Secured borrowing involves giving creditors rights to control the alienation of assets that are not present in unsecured lending. This

8 For reviews, see *ibid*; GG Triantis, 'Secured Debt Under Conditions of Imperfect Information' (1992) 21 Journal of Legal Studies 225; BE Adler, 'Secured Credit Contracts', in P Newman (ed), *The New Palgrave Dictionary Of Economics And The Law* (Basingstoke: Macmillan, 1998), Vol. 3, 405; J Tirole, *The Theory of Corporate Finance* (Princeton, NJ: Princeton University Press, 2006), 164–170; 251–254.

9 See, eg, H Bester, 'The Role of Collateral in Credit Markets with Imperfect Information' (1987) 31 European Economic Review 887.

10 See AN Berger and GF Udell, 'Collateral, Loan Quality, and Bank Risk' (1990) 25 Journal of Monetary Economics 21; SS Chen, GHH Yeo, and KW Ho, 'Further Evidence on the Determinants of Secured Versus Unsecured Loans' (1998) 25 Journal of Business Finance and Accounting 371; MA Lasfer, 'Debt Structure, Agency Costs and Firm's Size: An Empirical Investigation', working paper, Cass Business School (2000).

means that the marginal cost to the debtor of granting security, as opposed to borrowing unsecured, is therefore *decreasing* with the probability of default, because the "cost" is only incurred so long as the debtor does not default.[11] In other words, the early application of the signalling model in the literature was misspecified, deriving the inverse prediction. In fact, properly specified, willingness on the debtor's part may actually be a signal of *lack* of quality.[12]

3. Security and monitoring and bonding

A second theory posits social benefits from the use of secured credit as a means of preventing debtors from engaging in acts harmful to creditors' interests.[13] Security is thought to be able to assist creditors in lowering "financial agency costs"; that is, the costs of conflicts of interest between shareholders and creditors.[14] For example, if the business is financially distressed, shareholders – or managers acting on their behalf – may have incentives to pursue highly risky strategies that actually have a negative net present value, simply because they stand to benefit from the upside in the unlikely event that the strategy is successful. By restricting the ability of a debtor to alienate collateral, security enables the creditor to prevent the debtor from selling assets of stable value to fund more

11 This may be demonstrated formally as follows. Let b denote the private benefits the debtor enjoys from retaining complete control of the collateral and let p (where $0 < p < 1$) denote the probability of default. The additional cost of borrowing on a secured basis (as opposed to unsecured), from the debtor's point of view, which we will term c, is determined as follows: $c = (1 - p)\, b$. It can be seen that as $p \to 1$, $c \to 0$.

12 A point made by Kripke, above n 1, 969–970. It should be noted, however, that security can act as a signal of quality where it is given by a party other than the principal debtor. The clearest example is where a company director offers a guarantee of corporate debts: form the point of view of the guarantor, the cost of such an arrangement is clearly rising with the probability of default. Further, we may expect this cost to be priced into the deal by which the principal debtor induces the guarantor to offer this undertaking. So-called 'outside' security is thus a genuine signal of debtor quality.

13 CW Smith and JB Warner, 'Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment' (1979) 34 Journal of Finance 247.

14 MC Jensen and WH Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305, 333–343. The term 'financial agency costs' is taken from GG Triantis, 'A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities' (1994) 80 Virginia Law Review 2155, 2158. This account is, like the signalling theory, also based on mitigating the effects of asymmetric information. Whereas the signalling explanation focuses on asymmetries of information between debtor and creditor *prior* to contracting, the agency costs story focuses on asymmetries of information *after* a loan contract has been agreed.

risky business ventures. Security also restricts the debtor's ability to borrow to fund such ventures. By granting existing lenders priority to the firm's assets, security forces new lenders to look primarily to the value generated by the ventures they fund, and thereby to scrutinise more carefully the purposes for which the debtor is borrowing.[15]

On the agency costs view, the grant of security is thus a bond by the debtor not to engage in wealth-reducing transactions.[16] Such a bond is valuable to the debtor, because by "tying its hands" to prevent itself entering such transactions *ex post*, it increases its borrowing capacity *ex ante*.[17] This theory views security as closely related in function to loan covenants and contractual priority arrangements, which also impose restrictions on the debtor's freedom of action that may be justified as bonds against wealth-reducing transactions.[18] In each case, we would expect these arrangements only to be agreed to if the benefits to the debtor outweigh the costs – hence riskier firms, which we might expect to be more prone to financial agency costs, would be more likely to use loan covenants and security.

In this context, the utility of secured credit is a function of its advantages over and above contractual covenants.[19] The key to the difference lies in the consequences if the debtor ultimately defaults. As security creates proprietary rights, it is "self-enforcing", whereas loan covenants are not. Security also has another difference from loan covenants: it allocates control (subject to restrictions imposed by insolvency law) over the enforcement process.[20] This permits creditors to

15 A Schwartz, 'A Theory of Loan Priorities' (1989) 18 Journal of Legal Studies 209; O Hart, *Firms, Contracts and Financial Structure* (Oxford: Clarendon Press, 1995), 126–151. Were the existing lender not granted priority, the new lender would be able to poach, as its cushion against default, part of the "cushion" of assets which protected the earlier lender against the risk of default. The competitive interest rate required for the second loan would therefore be commensurately lower. In effect, the firm would have been able to secure finance at less than the competitive rate by expropriating the earlier creditor: Schwartz, *ibid*, 228–234.

16 See Triantis, above n 8.

17 The impact on debt capacity could be interpreted either as an interest rate reduction from the secured creditor, or, in a market characterised by credit rationing owing to adverse selection problems (see J Stiglitz and A Weiss, 'Credit Rationing in Markets with Imperfect Information' (1981) 71 American Economic Review 393, an increase in the amount of credit offered.

18 CW Smith and JB Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 Journal of Financial Economics 117; MJ Barclay and CW Smith, 'The Priority Structure of Corporate Liabilities' (1995) 50 Journal of Finance 899; GG Triantis, 'Financial Slack Policy and the Laws of Secured Transactions' (2000) 29 Journal of Legal Studies 35.

19 A Schwartz, 'Priority Contracts and Priority in Bankruptcy' (1997) 82 Cornell Law Review 1396.

20 RE Scott, 'The Truth About Secured Lending' (1997) 82 Cornell Law Review 1436.

allocate control over enforcement to those best-placed to maximise the value realised, and to deter other creditors from engaging in a wasteful "race to collect" when the debtor is in financial difficulty.[21] We would therefore expect security to be used by those firms which are riskiest, or about which creditors have least information. Risky firms are more likely to default, and hence more likely to go into insolvency proceedings. In keeping with these predictions, empirical studies from a number of jurisdictions establish that security tends to be used principally in relation to smaller, younger, and riskier firms.[22]

On this view, the ability of corporate debtors to grant security has the potential to yield social benefits extending beyond the parties to the security agreement (that is, "positive externalities")[23] *Ex ante,* by facilitating bonding and monitoring activity, security lowers the probability that the debtor will engage in wealth-reducing transactions, and helps to reduce the probability of default. This increases the value of all creditors' claims. *Ex post*, by facilitating efficient enforcement, it can increase the overall "size of the pie" for distribution.

4. Security and redistribution

A third theoretical explanation for the use of secured credit posits that it is or can be a mechanism for the transfer of wealth from one party to another. The mechanism for such wealth transfers depends on the presence of so-called "non-adjusting" creditors: that is, creditors whose decision to extend credit does not fully reflect the increased risk (to them) associated with the fact that the debtor has granted security.[24] The intuition is that, all other things being equal, a loan made on a secured rather than an unsecured basis will carry with it a lower rate of interest, reflecting the reduction in risk that the lender will bear. Correlatively, an unsecured creditor is worse off if his debtor has granted security to another creditor. Thus unless unsecured creditors "adjust" the terms of their credit to

21 RC Picker, 'Security Interests, Misbehaviour, and Common Pools' (1992) 59 University of Chicago Law Review 645.

22 See sources cited above n 10.

23 See Triantis, above n 8; S Schwarcz, 'The Easy Case for the Priority of Secured Claims in Bankruptcy' (1997) 47 Duke Law Journal 425; RJ Mokal, 'The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit' (2002) 22 Oxford Journal of Legal Studies 687.

24 JH Scott, Jr, 'Bankruptcy, Secured Debt and Optimal Capital Structure' (1977) 32 Journal of Finance 1; L LoPucki, 'The Unsecured Creditor's Bargain' (1994) 80 Virginia Law Review 1887; LA Bebchuk, and JM Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale Law Journal 857; V Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 Modern Law Review 633. The terminology "non-adjusting" is taken from Bebchuk and Fried, *ibid*, 885–886.

reflect the increased risk it brings for them, a grant of security may result in a transfer of wealth – in an expected-value sense – from unsecured debtors to the borrower.[25] By borrowing on a secured basis, the debtor obtains a lower interest rate; by failing to adjust, the "cost" is borne by unsecured creditors.

This claim does not necessarily imply that the benefits of security discussed in the previous section do not exist.[26] Yet at the very least it implies that, even if such benefits exist, the possibility of such wealth transfers will lead debtors to take "too much" security.[27] The costs of granting such "unnecessary" security will be wasted. Moreover, non-adjusting creditors who thereby end up bearing the additional risk may be poorly diversified and so least well-placed to bear it.[28] Determining the extent to which these theories account for the use of secured credit is, however, an empirical question, and so we now turn to the empirical literature.

5. Empirical studies

Doubt has sometimes been cast on propositions made in the theoretical literature regarding secured credit about interest rate reductions. Each of the theories about security – whether they characterise it as efficiency-enhancing or redistributive – posits that a debtor grants security because it receives an interest rate reduction for doing so. Yet empirically, it appears that secured loans granted by banks in the UK, Germany and France are associated with interest rates no lower than for unsecured loans.[29] This leads some to question the extent to which the theories describe reality.[30] However, it is important to note that the theoretical claims about interest rate reductions are made *ceteris paribus* – that is, all other

25 Even outside the case of the debtor's insolvency, unsecured creditors are prejudiced if their expected return on default decreases, should they wish to realise the value of the loan before maturity through a secondary market.

26 In its strongest form, this theory denies security has any social benefit, and is purely redistributive in operation. In a more modest form, proponents accept that security may have social benefits, but nevertheless point to the possibility for redistribution that may lead debtors to grant security to an extent greater than is efficient.

27 Bebchuk and Fried, above n 24, 895–903.

28 Finch, above n 24, 645.

29 SA Davydenko and JR Franks, 'Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK' forthcoming (2008) 63 Journal of Finance, available at www.ssrn.com, 49 (Table XII) (presence of security is, if anything, positively correlated with loan interest margins). However, *cf* H Fleisig, M Safavian, and N de la Peña, *Reforming Collateral Laws to Expand Access to Finance* (Washington, DC: World Bank, 2006), 6 (terms offered to Bolivian borrowers include lower interest rate for secured than unsecured loans).

30 See eg, RM Goode, *Principles of Corporate Insolvency Law*, 3rd ed (London: Sweet & Maxwell, 2005), 47.

things being equal. Both the agency costs theory and the redistribution theory predict that security will tend to be most valuable in relation to more risky borrowers. This means that when comparing secured and unsecured interest rates, all other things are not likely to be equal. Riskier borrowers would be likely to incur higher interest rates. So both security *and* increased interest rates are associated with riskier borrowers. Because of this selection effect, a comparison of interest rates for secured and unsecured loans may associate secured loans with higher interest rates. However, the appropriate comparison is rather with the terms on which borrowers with similar levels of credit risk to those observed to borrow on a secured basis would be offered *unsecured* credit. Studies which have sought explicitly to take this selection effect into account have found that borrowing on a secured basis tends to lower the cost of credit for debtors.[31]

Having clarified this point, we may now consider which of these theories derives most support from empirical studies of use of secured credit. As we have seen, in developed countries, security tends to be granted by firms which are at relatively greater risk of default.[32] This is consistent with the predictions of both the agency costs and redistribution theories. The benefits of policing a debtor so as to reduce their likelihood of default will clearly increase with the debtor's riskiness. At the same time, the expected value of the "insolvency share" of unsecured creditors, which the critics of security argue it permits to be "sold" to secured creditors, also increases with the probability of the debtor's default. Evidence on the types of firm that obtain secured credit is therefore inconclusive: it could be explained by reference to either, or a combination of both, effects.

More specific studies allow us to draw some distinctions between the theories of secured credit. A recent study by Yair Listokin sets out to test the redistributive theory directly.[33] Listokin examines the capital structures of firms of a type that are likely to have significant numbers of tort non-adjusting creditors: US tobacco manufacturers. The redistributive theory would predict that these firms, likely to be on the receiving end of mass tort litigation, would be likely to carry more secured credit than the average borrower. This is because the tort victims are unable to adjust the terms on which they become creditors to reflect their subordination to secured claims. As such, tobacco firms ought, if security is used to transfer wealth from non-adjusting creditors, to load up with secured debt. Yet Listokin finds the opposite: tobacco companies actually use *less* secured debt than average. This strongly contradicts the redistributive theory.

31 See JR Booth and LC Booth, 'Loan Collateral Decisions and Corporate Borrowing Costs' (2006) 38 Journal of Money, Credit and Banking 67; E Benmelich and N Bergman, 'Collateral Pricing', working paper, Harvard University Department of Economics/MIT Sloan School of Management (2007).

32 See above, n 10, and text thereto.

33 YJ Listokin, 'Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis', forthcoming (2008) 58 Duke Law Journal.

Other findings emerge from empirical studies that also tend to contradict the redistributive theory and support the agency costs view. Franks and Sussman, in a study of relations between UK banks and troubled borrowers, report that the presence of a secured corporate loan is correlated with the grant of personal guarantees by company directors.[34] Such guarantees assist the creditor in controlling debtor misbehaviour. Mokal argues that their presence also tends to contradict the view that security is granted in order to transfer value from non-adjusting creditors to the debtor.[35] This is because, to the extent that a grant of corporate security precipitates a grant of personal security by the debtor company's directors, the latter incur a cost by granting corporate security.

More generally, it seems unlikely that there are significant numbers of "non-adjusting" creditors, at least for firms outside the reach of US mass tort litigation. On the one hand, tort claims sufficient to bankrupt a defendant are rare outside the US.[36] On the other, the interests of tort victims are well-protected in the UK and in some other jurisdictions through systems of mandatory insurance for the most empirically significant categories of tort claim, coupled with statutory provisions that transfer an insolvent company's claim against a liability insurer to the injured party.[37]

Those claiming that security is used to transfer wealth typically assume that trade creditors' adjustment is only partial, on the basis that they face relatively high information and transaction costs relative to the amount at stake. Yet we have seen that security tends to be ubiquitous amongst smaller, younger firms.[38] *A priori*, it would be surprising if trade creditors could not use these borrower characteristics as readily observable proxies for whether or not security had been granted. Moreover, the assumption that trade creditors only adjust to a limited extent does not seem consistent with empirical data. Whilst trade creditors do tend to offer the same *terms* to all "borrowers" (that is, customers who purchase on credit),[39] the non-adjustment idea is contradicted by evidence that trade

34 J Franks and O Sussman, 'Financial Distress and Bank Restructuring of Small to Medium-Size UK Companies' (2005) 9 Review of Finance, 65, 80.

35 Mokal, above n 23, 713–717.

36 The author conducted interviews with approximately 20 Insolvency Practitioners during 1999–2000 (see J Armour and S Frisby, 'Rethinking Receivership' (2001) 21 Oxford Journal of Legal Studies 73, 102), amongst other things asking subjects whether they had ever had to deal with significant tort liabilities in relation to a case they had conducted. No subject was able to identify a case where this had occurred.

37 In the UK, this is done by the Third Parties (Rights Against Insurers) Act 1930.

38 See sources cited above, n 10.

39 Trade credit is typically offered on very similar terms within an industry: CK Ng, JK Smith and RL Smith, 'Evidence on the Determinants of Trade Credit Terms in Interfirm Trade' (1999) 54 Journal of Finance 1109, 1120–1121.

creditors tend to adjust the *amount* of trade credit granted in accordance with the debtor's creditworthiness and the scope for misbehaviour by the debtor.[40]

Thus, whilst it is possible that some grants of security may be harmful to non-adjusting creditors, it seems likely that the beneficial aspects of security are empirically more significant.

III. Domestic laws and secured credit

Clearly, the institution of secured credit must be facilitated by a country's legal system in order to function. The essence of the institution is a rule whereby one creditor is entitled to claim control and/or priority to payment from an asset as regards an open-ended set of other parties. However, the choices for policy-makers go far beyond a simple binary choice as to whether or not secured credit should be made available. Domestic systems of secured credit vary widely across a number of dimensions, from those granting plenary rights to senior creditors to those keeping the institution in much greater check. The economic implications of policy choices over four of these dimensions will now be considered: (i) the *scope* of the collateral over which security may be taken; (ii) the extent to which secured creditors are given more rapid powers of *enforcement* than unsecured creditors; (iii) the extent to which secured creditors are accorded *priority* over unsecured creditors; and (iv) the manner, and extent to which, efforts are made to bring the existence of security to the attention of *third parties* so as to facilitate their adjustment.

In the discussion that follows, we wish to focus on the effects of choices made across each dimension individually. In order to elucidate these, the effects of each are considered *ceteris paribus* – that is, "all other things being equal". Of course, in the real world, all other things are seldom equal, and so we should be very cautious about inferring that simply because *in theory* or *on aggregate* a particular change has a propensity towards a particular effect, that this will happen *in any given legal system* were such a change to be implemented. Most importantly, there are likely to be complementarities and substitutions between these different dimensions (and across others not discussed), such that national regimes which have formally different configurations may have functionally equivalent impacts on the real economy.[41]

40 See, eg, MA Petersen and RJ Rajan, 'Trade Credit: Theories and Evidence' (1997) 10 Review of Financial Studies 661, 678–679 (borrowers with observably higher credit quality obtain more trade credit); M Burkart, T Ellingsen, and M Giannetti, 'What You Sell is What You Lend? Explaining Trade Credit Contracts', ECGI Finance Working Paper 071/2005, November 2004 (more trade credit is granted where buyer is less able to divert inputs supplied to another use).

41 On the terminology, see RJ Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function' (2001) 49 American Journal of Comparative Law 329, 338–339.

It is commonly suggested in comparative discussions that common law systems are characteristically more liberal in their treatment of secured creditors' rights than are their civilian counterparts.[42] This receives some support from cross-country studies that seek to assign numerical values to the strength of creditor protection. A study of 129 countries using an index of creditor rights based on four aspects of the treatment of secured creditors in insolvency reports that jurisdictions the authors classify as being in the "French civil law" tradition have significantly weaker protection than do those classified as "common law", or "Germanic civil law".[43] A subsequent study has sought to measure differences across 60 different dimensions by which creditor rights may vary, in four leading developed jurisdictions: France, Germany, the US and the UK.[44] It also reports that the extent to which creditors are able to take security is more restricted in France than in the other jurisdictions considered. Thus the discussion can readily be interpreted as having implications for European policymakers.

1. Scope of collateral

Jurisdictions vary in the extent to which they permit security to be granted over a debtor's assets. Particular differences include the treatment of non-possessory security and of the availability of a general security interest over the entirety of a debtor's assets.[45] Theoretically, we may predict that the legal facilitation of both non-possessory security and general security interests will be associated with increased availability of debt finance.

The theoretical case for non-possessory security is straightforward. Requiring a creditor to take possession of the collateral greatly increases the cost to the debtor of granting security, and may impede the debtor's ability to conduct his business: the debtor is likely to have comparative advantage, as against the

42 See, eg, PR Wood, *Maps of World Financial Law*, 5th ed (London: Allen & Overy LLP, 2005), 89–105.

43 See S Djankov, C McLiesh and A Shleifer, 'Private Credit in 129 Countries' (2007) 84 Journal of Financial Economics 299, 308. It should be noted that there are significant doubts amongst comparative lawyers as to whether the exercise of seeking to classify so many countries into a limited number of legal 'families' is meaningful: see M Siems, 'Legal Origins – Reconciling Law & Finance and Comparative Law' (2007) 52 McGill Law Journal 55.

44 J Armour, S Deakin, P Lele and M Siems, 'How Does Law Evolve? Evidence from Cross-Country Data', working paper, University of Cambridge Centre for Business Research (2007).

45 See, eg, Wood, above n 42, 90–91; JH Röver, *Secured Lending in Eastern Europe: Comparative Law of Secured Transactions and the EBRD Model Law* (Oxford: Oxford University Press, 2007), 161–166; M Bridge, 'The Scope and Limits of Security Interests' (2008) 5 European Company and Financial Law Review.

creditor, in putting his assets to use in his business. Thus we would expect restrictions on the use of non-possessory security to impose a significant constraint on the use of secured credit. If security has the benefits posited above, we would anticipate that the introduction of non-possessory security would increase the availability of debt finance.

Empirically, the transition economies of Eastern Europe provide an interesting "natural experiment" regarding the introduction of non-possessory security. Whilst in the early 1990s all of these economies made available at least a basic security interest such as a mortgage of land, many did not permit non-possessory security interests. Haselmann, Pistor and Vig examine the impact on bank lending practices of changes in the laws of these countries relating to secured credit and bankruptcy during the period 1994–2002.[46] They use a simple index of collateral involving three measures: whether land may be taken as security; whether non-possessory security interests are recognised; and whether non-possessory security interests must be registered. Haselmann *et al* report that changes in collateral laws – the introduction of non-possessory security and associated registration mechanisms – are precursors to increases in bank lending to firms in the country in question in subsequent years, controlling for a range of other factors.[47] Moreover, the impact on bank lending of changes in collateral laws is more significant than changes in bankruptcy laws. Complementing this finding about banks' lending decisions, a study by Safavian and Sharma examines the impact of such changes on firms' access to finance.[48] They report that expansions in the scope of secured creditors' rights in 27 European countries during the period 2002–2005 were associated with increases in the amount of finance raised by firms. Facilitating greater scope for security appears therefore to stimulate lending and facilitate access to finance for firms.

A second important dimension over which secured credit regimes differ concerns the availability, or otherwise, of general security interests covering the entirety of the debtor's assets. The theoretical case for such interests depends on a demonstration that the way in which security generates benefits depends in part upon the identity and lending strategy of the creditor and the scope of the

46 R Haselmann, K Pistor, and V Vig, 'How Law Affects Lending', Columbia Law and Economics Working Paper No 285 (2006).

47 An obvious concern with such a study is the risk of endogeneity – that is, that changes in collateral laws are themselves triggered by increases in lending. The authors respond to this by testing for links between changes in collateral laws and differences in the supply of credit one year later. The interpretation that legal changes in credit markets cause changes in collateral laws in previous years is implausible, thereby clarifying the direction of any causal links.

48 M Safavian and S Sharma, 'When Do Creditor Rights Work?', World Bank Policy Research Working Paper No 4296 (2007), 36 (Table 8).

collateral. In the discussion that follows, we consider first the case of security over specific assets, and secondly, the case of general security over the entirety of a debtor's assets.[49]

Consider first a security interest in a single asset, or a particular class of assets.[50] This would be a natural complement for a creditor following an asset-based lending strategy. Such a lender relies not upon its predictions about the debtor firm's creditworthiness, but on the ability of specific asset classes to cover repayment.[51] Such a security interest is therefore most valuable for a financier who has specialist knowledge about the asset class in question, and/or the market(s) in which it is sold. The lender's expertise would enable her to exercise her control rights effectively, and thereby facilitate the monitoring of the debtor's use of the collateral and – should default occur – enforcement against it. Moreover, the *priority* associated with the security interest can sharpen the lender's incentive to do so. As the lender's priority will be limited to the proceeds of sale of these assets, this will focus her attention on the fate of that asset, as opposed to that of the debtor company's business generally.[52] Thus a security interest in a particular asset is most usefully granted to a creditor with specialist knowledge regarding the asset class in question. It not only allocates control rights to the party best placed to exercise them, but also gives the lender a powerful incentive to care about how they are exercised.

Now consider a general "floating" security interest, over the entirety of the debtor's assets. In contrast to asset financiers, the approach generally adopted by banks is to advance funds on the basis of the debtor's general business prospects. A bank's credit decision could either be made using publicly available financial information, or could involve the creditor developing a relationship with the debtor where "soft" information may be gathered on an ongoing basis to assist in making decisions about further advances in the future – so called "relationship" lending.[53]

A lender advancing credit on business-based criteria may be expected to invest in specialist knowledge about business generally, or – in the case of relationship lending – the debtor's business in particular. Granting a general security

49 The discussion in this section draws on J Armour, 'Should We Redistribute in Insolvency?' in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford: OUP, 2006), 189, 208–212.

50 The following discussion holds equally if the transaction is structured as a title retention, hire purchase, or finance lease, each of which is functionally similar to a security interest in a specific asset.

51 See AN Berger and GF Udell, 'Small Business and Debt Finance' in ZJ Acs and DB Audretsch (eds), *Handbook of Entrepreneurship Research: An Interdisciplinary Survey and Introduction* (Boston, MA: Kluwer, 2003).

52 S Levmore, 'Monitors and Freeriders in Commercial and Corporate Settings' (1982) 92 Yale Law Journal 49; SD Longhofer and JAC Santos, 'The Paradox of Priority' (2003) 32 Financial Management 69.

53 See Berger and Udell, above n 51.

interest to such a lender can assist in controlling financial agency costs.[54] Where the debtor is relatively high-risk – as is the case with small businesses – then a relatively tight control is called for.[55] Giving veto rights to a range of creditors will lead to coordination costs in their decision-making. In contrast, concentrating the decision rights in the hands of a single, well-informed, creditor (which for simplicity we will call a "bank") may be the most efficient way of managing the problem.[56] Financial economists speak of the bank acting as a "delegated" monitor on behalf of the other creditors.[57]

It might be thought that the priority associated with such a general security would weaken the bank's incentive to invest in gathering information about, and monitoring, the debtor's business.[58] The intuition is that if the bank is a senior claimant, it will not be sufficiently concerned with monitoring the debtor. This intuition is based on two assumptions: (i) that more creditor control is always better than less; and (ii) that a junior creditor always has the strongest incentives to monitor. However, it may be that neither is reliable.

Creditor control has significant costs as well as benefits. These costs are the inverse of the costs of shareholder control. Just as the shareholders have an incentive to prefer excess risk; creditors have an incentive to prefer too *little* risk.[59] And just as shareholder's incentives are misaligned from maximising the firm's value when it is financially distressed, creditors' incentives are misaligned from value maximisation when it is solvent. It follows that the more financially distressed the debtor's position, the greater will be the benefits of creditor control, and the lower the costs. Thus it makes sense to give a concentrated creditor an incentive to intervene which will become progressively greater with the severity of the firm's financial distress.

However, a junior creditor's incentive (and ability) to exert control does not increase in linear fashion with the financial difficulties of the firm as a whole. Rather, a junior creditor's incentive to intervene begins early, when its claim is "close to the money". This may result in too much creditor "discipline" for the

54 RE Scott, 'A Relational Theory of Secured Financing' (1986) 86 Columbia Law Review 901, 926–929; Armour and Frisby, above n 36, 79–86.

55 See M Carey, M Post and SA Sharpe, 'Does Corporate Lending by Banks and Finance Companies Differ? Evidence on Specialization in Private Debt Contracting' (1998) 53 Journal of Finance 845, 847.

56 MA Petersen and RJ Rajan, 'The Benefits of Lending Relationships: Evidence from Small Business Data' (1994) 49 Journal of Finance 3.

57 See, eg, DW Diamond, 'Financial Intermediation and Delegated Monitoring' (1984) 51 Review of Economic Studies 393.

58 Jackson and Kronman, above n 6, 1149–1161; E Fama, 'Contract Costs and Financing Decisions' (1990) 63 Journal of Business S71, S84; Finch, above n 24, 258.

59 Jensen and Meckling, above n 14.

firm.[60] Moreover, if the firm's financial position deteriorates seriously, a junior creditor will find its incentive and ability to intervene will decline, at the very point when it is potentially most valuable. Its incentive will be dulled by the fact that the marginal benefit of its efforts will now go to creditors ranked above it.[61] Its ability to influence the debtor by threatening insolvency proceedings will weaken. The threat will cease to be credible as the creditor's likelihood of repayment in insolvency diminishes.[62] Thus making bank debt senior may give the concentrated creditor an incentive to intervene when it matters most, and the ability to exert meaningful control.

That banks, with senior priority status, do in fact exercise this control when the debtor is financially distressed, in a way that is beneficial for other creditors, is apparent from empirical studies of banks' orchestration of informal rescues in the UK.[63] Franks and Sussman found that the average firm in their sample of financially distressed borrowers spent seven and a half months with banks' Business Support Units, and that – depending on the bank – somewhere between half to three quarters of these firms emerged from the process without going into formal insolvency proceedings.[64] Moreover, this is put into comparative context by a recent study of banks' recoveries in insolvencies in the UK, France and Germany.[65] The authors note that, despite the relatively high level of control rights accorded to creditors in the UK, as compared with the two other jurisdictions in their study, the incidence of formal insolvencies was actually *lower* – and the use of informal "workouts" correspondingly *higher* – in the UK than the other two countries. They attribute this to, amongst other things, the greater control rights granted to UK lenders through the use of general security.[66] The theoretical claim that the availability of general security – covering the entirety of the debtor's assets – will tend to generate additional benefits over and above specific security therefore seems to find some empirical support.

60 DW Diamond, 'Seniority and Maturity of Debt Contracts' (1993) 33 Journal of Financial Economics 341.

61 C Park, 'Monitoring and the Structure of Debt Contracts' (2000) 55 Journal of Finance 2157; SD Longhofer and JAC Santos, 'The Importance of Bank Seniority for Relationship Lending' (2000) 9 Journal of Financial Intermediation 57.

62 Park, *ibid*; R Elsas and JP Krahnen, 'Collateral, Relationship Lending and Financial Distress: An Empirical Study on Financial Contracting', working paper, Department of Finance, Goethe-Universität Frankfurt (2002).

63 Armour and Frisby, above n 36, 91–95; Franks and Sussman, above n 34, 84–93. See also, in an historical context, M Baker and M Collins, 'English Commercial Banks and Business Client Distress, 1946–63' (2003) 7 European Review of Economic History 365.

64 Franks and Sussman, above n 34, 76–77.

65 Davydenko and Franks, above n 29.

66 *Ibid*, 21.

To summarise the conclusions of this section: in theory, the facilitation of more extensive security – both in terms of the types of assets over which security may be granted, and the facilitation of a general wraparound security interest – is likely to foster access to credit and assist in reducing default risk for borrowers. Empirically, the introduction of non-possessory security is associated with greater availability of credit. The empirical literature on general security interests suggests that they may facilitate out-of-court restructurings of distressed firms.

2. Enforcement of security

The procedures which must be followed prior to the enforcement of security against collateral also vary widely across legal regimes.[67] Intuitively, we might expect that the more powerful the enforcement mechanism, the more effective security will be as a means of controlling debtor misbehaviour, because the "threat value" of the collateral will increase.[68] Consequentially, we would expect stronger enforcement rights to be associated with greater availability of credit, less use of collateral for equivalent levels of borrowing, and lower interest rates. Empirical support exists for each of these propositions.[69] Most strikingly, in their study of the impact of changes in secured creditors' rights across 27 European jurisdictions between 2002 and 2005 on firms' access to bank loans, Safavian and Sharma found that changes in the law had "little impact" in the presence of poor enforcement, but a "remarkable" effect where enforcement was effective.[70]

Having considered the case for facilitating enforcement of security *generally*, it is worth turning to a particularly difficult subset of issues – namely the extent to which secured creditors are permitted to enforce *in the insolvency of the debtor*.[71] The first point to note in this regard is that granting secured creditors

67 See generally, Röver, above n 45, 289; E Dirix, 'Remedies of Secured Creditors Outside Insolvency' (2008) 5 European Company and Financial Law Review.

68 See Tirole, above n 8, 540.

69 See J Qian and PE Strahan, 'How Law and Institutions Shape Financial Contracts: The Case of Bank Loans', working paper, Boston College and Wharton Financial Institutions Center (2004) (when a country's laws provide stronger protection of creditor rights, interest rates are lower, lenders use less collateral); V Vig, 'Access to Collateral and Corporate Debt Structure: Evidence from a Natural Experiment', working paper, Columbia University Business School (2006) (enhancement of enforcement rights of secured creditors in India in 2002 resulted in less use of collateral).

70 Safavian and Sharma, above n 48, 15–17. The "effectiveness" of enforcement was measured using indicators based on (i) length of time in judicial proceedings and (ii) survey evidence on domestic firms' perceptions as to confidence in judicial enforcement: *ibid*, 29.

71 See generally, M Brinkmann, 'The Position of Secured Creditors in Insolvency' (2008) 5 European Company and Financial Law Review.

plenary enforcement rights in insolvency creates a potential problem. If there are multiple secured creditors, each having taken collateral over a particular asset or group of assets, then their simultaneous enforcement will lead to the dismemberment of the debtor's business, and loss of any "going concern" surplus.[72] That is, where the firm's assets may be worth more as a going concern than if broken up and sold separately, then the seizure of particular assets by secured creditors will result in a loss of overall value *ex post*. For this reason, it may be desirable to stay the enforcement of security on the debtor's insolvency, through a moratorium or "automatic stay".

It is, however, important to understand the limits to the previous point's implications. First, it only provides a rationale for staying the enforcement of security insofar as there is in fact a going concern surplus to be realised. In many cases of business insolvency, the firm is "economically distressed" – that is, its assets are worth more in some other use.[73] Under such circumstances, there will be no necessary synergies to liquidating the firm's assets together, as opposed to piecemeal. Staying secured creditors will not lead to higher realisations for the firm's assets. It will, however, impose delay costs on secured creditors, and hence a net social loss. To be sure, it may not be apparent at the commencement of insolvency proceedings whether a going concern exists. Under such uncertainty, it may make sense to have a presumptive stay, which can be waived in cases where it becomes clear that there is no going concern surplus generally, or that a particular asset in which security subsists is unnecessary to the successful continuation of the firm's business.[74]

Secondly, concerns about dismemberment of the debtor's business by secured creditors do not extend to the enforcement of general floating security interests over the entirety of the debtor's assets.[75] This is because the enforcement of such a security interest can involve the sale of all of the debtor's assets, either together as a going concern, or broken up on a piecemeal basis, as is appropriate. This

72 TH Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 Yale Law Journal 857, 864–865; D Webb, 'An Economic Evaluation of Insolvency Processes in the UK: Does the 1986 Insolvency Act Satisfy the Creditors' Bargain' (1991) 43 Oxford Economic Papers 139, 143–146.

73 On the terminology, see, eg, DG Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108 Yale Law Journal 573, 580.

74 Such a strategy is, for example, adopted in English administration proceedings, in which a moratorium is presumptively imposed on the enforcement of security, but may be waived if the secured creditor applies to the court and the administrator is unable to demonstrate that the asset concerned is necessary for the realisation of going-concern surplus: see, eg, *Re Atlantic Computer Systems plc* [1990] BCC 859, 880–882.

75 Picker, above n 21; FH Buckley, 'The American Stay' (1994) 3 Southern California Interdisciplinary Law Journal 733; Armour and Frisby, above n 36.

mode of enforcement was, until recently, permitted in the UK for the holder of a floating charge covering all, or substantially all, of the debtor company's assets, where the process was known as "administrative receivership".[76]

However, a different problem arises where a single creditor enforces a general hypothecation. This does not so much concern the possible dismemberment of the business, but rather that giving control over the realisation of the assets to a creditor with a senior priority position might result in them applying less effort in realising them than might be optimal. This might happen where the value of the company's assets is greater than the amount owing to the secured creditor. Under such circumstances, the creditor lacks an incentive to expend effort on realising the assets for more than the amount of the secured claim. This would reduce recoveries for unsecured creditors and potentially lead to the inappropriate closure of good firms.[77]

Theoretical literature has debated how great a problem this "perverse incentive" problem actually is. To be sure, if the secured creditor is not in fact oversecured, then it is the residual claimant in the debtor's insolvency, and has perfectly aligned incentives to carry out the liquidation of the collateral.[78] However, concern over possible lost value where the secured creditor was oversecured lead the UK government to abolish (prospectively) the administrative receivership procedure from 2003, and to replace it with a more collective mechanism, administration.[79] This places the administrator running the case under a fiduciary duty to act in the interests of all creditors, and requires him to refer his proposals to a vote of the unsecured creditors.[80] However, control by unsecured creditors may not be a panacea: it brings with it increased coordination costs, and reduced decision-making efficiency, because the unsecured creditors are more dispersed and typically less well-informed about the debtor company's business than would be a single secured creditor in a relational lending association with a debtor.[81]

Two recent empirical studies appear to bear out the idea that control by a single secured creditor, who is owed a large proportion of the firm's outstanding

76 See generally G Lightman and G Moss, *The Law of Administrators and Receivers of Companies*, 4th ed (London: Sweet & Maxwell, 2007).

77 Hart, above n 15, 168 n 17.

78 Armour and Frisby, above n 36, 90–91.

79 Insolvency Service, *Productivity and Enterprise: Insolvency – A Second Chance*, Cm 5234 (2001), 9; RJ Mokal, 'Administrative Receivership and Administration – An Analysis' (2004) 57 Current Legal Problems 355.

80 For details, see S Frisby, 'In Search of a Rescue Culture – The Enterprise Act 2002' (2004) 67 Modern Law Review 247; J Armour and RJ Mokal, 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002' (2005) Lloyds' Maritime and Commercial Law Quarterly 28; R Stevens, 'Security After the Enterprise Act', in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford: OUP, 2006), 153.

81 Armour and Frisby, above n 36, 84–86.

debt, does no worse in generating recoveries for creditors than does control of a collectivised insolvency process by unsecured creditors. In the first of these, Djankov *et al* study the operation of insolvency procedures around the world, which they divide roughly into "foreclosure" procedures (run for the benefit of secured lenders) and "reorganisation" procedures (run for the benefit of the creditors collectively).[82] They ask practitioners in each jurisdiction to estimate likely recoveries for a hypothetical case. The results suggest that, for this set of facts, "foreclosure" procedures where general floating charge security is available are in fact more efficient – measured by time, costs, and propensity to allocate the debtor's assets to their highest-valued use, than "reorganisation" procedures.[83] The second study, by Armour *et al*,[84] is an empirical investigation of the impact of the change in UK insolvency law that replaced the administrative receivership procedure with the more collective administration. The authors find that whilst overall realisations have increased under the new procedure – and, in keeping with the criticisms of foreclosure procedures, the increase is principally found in cases where the debtor is oversecured – so too have costs, such that there appears to be little overall difference for unsecured creditors.[85]

To conclude this section: it appears desirable to permit secured creditors to enforce effectively, to the greatest degree possible, outside of insolvency, and even in insolvency proceedings if there is no going concern surplus to be realised. Even where a going concern surplus exists in insolvency, enforcement by a single secured creditor may on average achieve outcomes that are not significantly different from a more collectivised process.

3. Priority and redistribution

It is a core feature of security that the secured creditor enjoys a right to priority of payment from the sale of the collateral on enforcement. In the debtor's insolvency, this right entitles the secured creditor to payment ahead of the general unsecured creditors. However, concerns about the possible redistributive features of

82 S Djankov, O Hart, C McLiesh and A Shleifer, 'Debt Enforcement Around the World', NBER Working Paper No. 12807 (2006).

83 *Ibid*, 28.

84 J Armour, A Hsu, and A Walters, 'The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK', ESRC Centre for Business Research Working Paper No 332 (2006).

85 In a related study, Frisby finds that recoveries for unsecured creditors have increased slightly under the new procedure, from an average of 1.9 % to 2.8 % of face value (S Frisby, *Interim Report to the Insolvency Service on Returns to Creditors from Pre- and Post-Enterprise Act Insolvency Procedures* (2007), 5, 34–43). However, it is not reported whether these differences are statistically significant in the sample.

security discussed in section II. 4. above lead some to argue that the claims of secured creditors should be subordinated to the claims of certain unsecured creditors.

One suggestion, first proposed by David Leebron, is to prioritise the claims of non-adjusting creditors – principally, tort victims – ahead of all other creditors.[86] This would mean that the firm's likely exposure to non-adjusting creditors would affect the expected payoffs in default of the firms *adjusting* creditors. Hence these creditors – who do bargain over the terms of their loans – would take this likely exposure into account *ex ante* when negotiating. This would encourage the firm to internalise the expected costs of its activities vis-à-vis non-adjusting claimants.

A more extensive policy involves a (partial) subordination of secured creditors in favour of unsecured creditors generally, on the basis that distinguishing between adjusting and non-adjusting creditors may be difficult to do, and that most unsecured creditors are in any event likely to have made incomplete adjustment to the risk of the debtor's insolvency.[87] To avoid this amounting to the effective abolition of secured credit, the proposal is usually made for some limit on the extent to which subordination occurs – for example, that it be effective only with respect to a fixed percentage of the collateral, or only up to a fixed ceiling in value, or both.

Clearly, such statutory subordination will tend to reduce the value of secured credit to lenders. Yet at the same time such a change may be expected to have a positive impact on unsecured creditors, or those groups of unsecured creditors which are prioritised. To the extent that such creditors are unable to adjust *ex ante*, this may, as with Leebron's proposal, be expected to have a positive effect on debtor firms' incentives to internalise risk that otherwise might fall onto unsecured creditors. However, to the extent that unsecured creditors *are* able to adjust their claims *ex ante*, such *ex post* redistribution simply reallocates value as between two classes of claimant. This may be thought to have two potentially undesirable effects. First, it may affect firms' financing choices, by biasing them against the use of particular forms of secured debt. At the margin, unsecured debt may become more attractive relative to secured debt. More significantly, lenders may substitute asset-based financing techniques involving true sales (such as factoring or invoice discounting of receivables, or sale-and-leaseback transactions with respect to tangible assets) for secured debt that might previously have been used. To the extent that certain forms of secured debt may yield "positive externalities" for unsecured creditors that these substitutes do not, this may be a retrograde step. Secondly, the very process of effecting redistributive payments

86 D Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91 Columbia Law Review 1565.

87 Insolvency Law Review Committee, *Insolvency Law and Practice* (1982), Cmnd 8558, paras 1538–1549; Bebchuk and Fried, above n 24, 904–912; Finch, above n 24, 664–665.

will be costly, and if no additional value is created by the transfer (as with a transfer from one adjusting creditor to another) then this cost is simply a deadweight loss to society.[88]

Some light may be shed on these issues by the experience of jurisdictions which have enacted such partial priority rules. In Finland, recoveries from security interests over circulating assets were, from 1993, subjected to a 40 % carve-out in favour of unsecured creditors.[89] Bergström *et al* study the effect of this on recoveries and costs in Finnish insolvency proceedings. As might be expected, there is an increase in recoveries for unsecured creditors (from, on average, 0.9 % of face value to 4.0 %);[90] contrary to some predictions, however, the implementation does not appear to have resulted in any increased direct costs in insolvency proceedings.[91] As the authors of the study acknowledge, their data includes only *ex post* variables on outcomes in insolvency, and so does not permit them to investigate whether or not the change resulted in differences in firms' financial structures. A similar change in priorities was adopted in the UK in 2003, requiring that a proportion of the recoveries from floating charges created after this date, known as the "prescribed part", be set aside to satisfy unsecured creditors' claims.[92] There is some evidence that this may have encouraged a substitution from floating charges to more use of asset-based finance, and that consequently this may be hampering the resolution of financial distress by increasing the number of negotiating parties.[93] More general evidence on the *ex ante* impact of differences in priority comes from a cross-sectional study of secured lending in the UK, France, and Germany. The authors find that in jurisdictions where statutory re-ordering of priorities occurs, creditors demand a higher ratio of collateral to loan value, and focus their lending activity to a greater degree on classes of collateral not subject to such re-ordering.[94]

The following tentative conclusions may be drawn from this section. *Ex post* redistribution can result in increased recoveries for unsecured creditors, and its implementation does not appear to generate significant additional direct costs in insolvency proceedings. Where the beneficiaries are non-adjusting creditors, this

88 See D Baird, 'The Importance of Priority' (1997) 82 Cornell Law Review 1420, 1431–1435.

89 See C Bergström, T Eisenberg, and S Sundgren, 'On the Design of Efficient Priority Rules for Secured Creditors: Empirical Evidence from a Change in Law' (2004) 18 European Journal of Law and Economics 273, 275–277.

90 *Ibid*, 282–284.

91 *Ibid*, 287–288.

92 Insolvency Act 1986 s 176A. The relevant amount is 50 % of the first £10,000, then 20 % of subsequent realisations up to a ceiling of £600,000.

93 Armour, above n 49, 202–206, 219–220; S Frisby, *Report on Insolvency Outcomes*, Report prepared for Insolvency Service (2006), 32–43, available at http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs.htm.

94 See Davydenko and Franks, above n 29.

may encourage debtors to internalise the costs that their activities may impose on such parties. However, such redistribution may also be associated with a reduction in the use of any types of secured credit which are subjected to subordination. Where it is easy for creditors to substitute into different types of financing structure, this may defeat the object of subordination, and may detract from some of the benefits of having secured credit in a capital structure. That said, the effects either way do not appear to be particularly large.

4. Informing third parties

All jurisdictions permitting non-possessory security implement some mechanism for bringing the existence of security interests to the attention of other creditors.[95] It is common to combine this with rules that deny proprietary effect to security interests that are not appropriately publicised. In simple terms, the policy goal here might be understood as a desire to minimise the search costs that subsequent parties – whether they are adjusting creditors or purchasers of assets potentially subject to security interests – may need to incur in order to determine the extent of any security previously granted by the debtor.[96] However, there may be a trade-off to be made between facilitating discovery by third parties and permitting customisation and innovation in the nature and use of security, as between debtor and creditor.

Broadly speaking, legal systems employ three types of strategy to reduce the search costs of subsequent creditors.[97] The first strategy, historically characteristic of civil law regimes, is to limit the varieties of security interest which may be granted, and the extent to which they may be customised, to a fixed list, or *numerus clausus*. The idea in this case is that parties operating within the system will familiarise themselves with and learn the contents of the list, so being aware, at least in general terms, of the types of interest which may be used. This understanding can be used to reduce their search routines into a list of questions or enquiries specific to the interests on the list.[98] A second mechanism, historically

95 See generally, Röver, above n 45, 230–232, HG Sigman, 'Perfection and Priority of Security Interests' (2008) 5 European Company and Financial Law Review.

96 It is worth noting that as regards creditors who are unable to adjust the terms on which they lend, mandatory disclosure of security interests will have no effect.

97 See J Armour and MJ Whincop, 'The Proprietary Foundations of Corporate Law' (2007) 27 Oxford Journal of Legal Studies 429, 455–459.

98 B Rudden, 'Economic Theory v. Property Law: The *Numerus Clausus* Problem', in J Eekelaar and J Bell (eds), *Oxford Essays on Jurisprudence,* 3rd ed (Oxford: Oxford University Press, 1987), 239, 254–256; U Mattei, *Basic Principles of Property Law* (Westport, CT: Greenwood Press, 2000), 39; TW Merrill and HE Smith, 'Optimal Standardization in the Law of Property: The *Numerus Clausus* Principle', (2000) 110 Yale Law Journal 1, 38–41.

characteristic of common law systems' treatment of non-possessory equitable proprietary rights, is what may be termed "selective enforcement".[99] Under this strategy, non-possessory proprietary rights are only enforceable against third parties if (broadly speaking) that party's costs to discover the right's existence would be lower than the costs the holder of the right would incur to publicise the right's existence. In other words, something that may be roughly equated with a "least-cost avoider" analysis is applied to determine whether or not such proprietary rights should be effective.[100] In legal terms, this is the application of a (contextual) "constructive notice" rule: the third party may succeed in trumping the holder of the non-possessory proprietary right if they are unable to discover at low cost that an asset is subject to such a right.

A third technique, now employed in many jurisdictions, is to require those taking security interests to publicise their existence through inclusion on some variety of public register.[101] Here, the search costs of creditors are reduced by examining the register to determine the existence of security interests. The extent to which this is effective depends, however, on the technology employed to disseminate information on the register. Historically, the transaction costs associated with the use of public registers were very high, and so the *numerus clausus* and selective enforcement strategies were realistic alternatives. However, the advent of the internet has greatly reduced the costs involved in updating and searching registers, giving this strategy a clear advantage, at least in theory, over the others.

The choice of publicity strategy affects more than third parties' search costs. Each of these strategies also has some degree of impact on the extent to which debtors and creditors may customise or innovate over aspects of security interests. Under a *numerus clausus* regime, for example, new types of security interest cannot readily be countenanced. In contrast, selective enforcement allows for much greater innovation in financial contracts, although it requires greater judicial

99 J Armour and MJ Whincop, 'An Economic Analysis of Shared Property in Partnership and Close Corporations Law' (2001) 26 Journal of Corporation Law 983, 993–994; Armour and Whincop, above n 97, 456–457.

100 See A Schwartz and RE Scott, *Commercial Transactions: Principles and Policies*, 2nd ed (Westbury, NY: Foundation Press, 1991), 488–494; MJ Whincop, 'Nexuses of Contracts, The Authority of Corporate Agents, and Doctrinal Indeterminacy: From Formalism to Law and Economics' (1997) 20 University of New South Wales Law Journal 274, 284–97; D Fox, 'Constructive Notice and Knowing Receipt: An Economic Analysis' [1998] 57 Cambridge Law Journal 391.

101 DG Baird, 'Notice Filing and the Problem of Ostensible Ownership' (1983) 12 Journal of Legal Studies 53; H Hansmann and R Kraakman, 'Property, Contract, and Verification: The *Numerus Clausus* Problem and the Divisibility of Rights' (2002) 31 Journal of Legal Studies S373.

engagement with specific facts.[102] Under a selective enforcement regime, the contours of a security interest can in principle vary according to how debtor and creditor find it to their mutual advantage to arrange things: however, this will only bind third parties to the extent that they are able to discover the terms at low cost.

Turning to the registration strategy, the impact on customisation and innovation depends on the particular way in which the system operates. Some are structured so as to specify a list of types of security interest that must be registered, and the details which must be included in the public notice. We may term this a "specific" registration system. An example of this type of approach is found in the UK's companies legislation, which sets out a list of different types of security that are registrable, and specifies the type of information that must be disclosed.[103] Others apply a more general test, utilising a functional or open-ended definition of what counts as a registrable security interest, and impose minimal obligations concerning the content of disclosure. We may term this a "generic" registration system. Article 9 of the Uniform Commercial Code is perhaps the best-known example of such a system. This applies to any "security interest" falling within an open-ended functional test,[104] and requires very little in the way of notification other than the names of the parties.[105]

As between the two, it will be seen that the more specific the determination of which types of security are registrable and what must be registered, the lesser innovation as regards the scope and terms of the security interest may be permissible. That is, having a fixed list of registrable securities is akin to a form of the *numerus clausus* principle, and tends to focus attention on the characteristics of particular types of security; whereas a generic test, by avoiding this, permits greater customisation and innovation in the form of security arrangements. This may be thought to come at the price of higher search costs for third parties: a generic registration system does not specify particular details that must be regis-

102 Perhaps because of the need for *ex post* judicial regulation, the traditional equitable rules regarding selective enforcement against third parties applied in the case of purchasers of collateral, but not to subsequent creditors, who were always subordinated; perhaps because the intensive evidential requirements associated with the selective enforcement strategy made it inappropriate for application should the debtor subsequently become insolvent several years later.

103 See Companies Act 2006, ss 860(7) (types of registrable security), 869(4) (particulars to be registered).

104 UCC §§ 1-201(b)(35) ("'security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation"); 9-109(a)(1) ("this article applies to a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract").

105 UCC § 9-502(a) (financing statement must contain (1) debtor's name; (2) secured party's name; (3) indicate the collateral covered).

tered in relation to a security interest, and hence requires third parties not only to consult the register, but also to seek warranties from the debtor or to consult the secured creditor as to the scope and nature of the security. However, the benefit of a specific registration system, in terms of third party search costs, may be illusory. This is because even a specific registration system is unlikely to provide all details that subsequent lenders wish to know, hence necessitating them to consult the secured creditor in any event. Under such circumstances, the costs associated with the transmission of the specific registration information may be wasted.

It can be seen that the choice of mechanism for disseminating information about the existence of security interests has implications not only for the search costs of third parties, but also for the ability of lenders and borrowers to customise and innovate secured credit arrangements. This latter ability may have important benefits for the provision of finance.[106] The literature on this topic is relatively underdeveloped compared to many of the other issues discussed, and so any conclusions must be tentative. Nevertheless, it seems tolerably clear that the restriction of customisation and innovation is a serious limitation of the *numerus clausus* approach. As between the other mechanisms, both a selective enforcement strategy and a generic registration regime are capable of achieving a trade-off between customisation and search costs. Of these two, a registration regime seems clearly preferable for any kind of pan-European endeavour. This is because selective enforcement works best when third parties have relatively homogeneous expectations regarding the dimensions of security interests. However, as domestic laws differ widely, such an approach would be better avoided at the European level. A generic registration system would notify third parties of the identity of secured creditors, but not the dimensions of their security, which could be left to private enquiry.

IV. Conclusions

This essay has surveyed the law and economics literature on secured credit, with a view to extracting propositions salient to European lawmakers. It seems clear that the empirical turn in the law and economics literature means that it is able to offer more lessons for European law-making than might previously have been imagined. Of the theories that have been advanced to explain the use of secured credit, the most plausible is that it functions to assist creditors in

106 See NR Lamoreaux and J-L Rosenthal, 'Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialization' (2005) 7 American Law and Economics Review 28.

monitoring debtor behaviour, and in bonding debtors not to misbehave. This theory views secured credit as a beneficial social institution. The alternative view, that security functions to effect redistribution from non-adjusting creditors, receives scant support from the empirical literature. The starting point for discussion by lawmakers is therefore that security has the potential to generate social benefits, through reducing the default risk of marginal firms.

In theory, the facilitation of more extensive security – both in terms of the types of assets over which security may be granted, and the facilitation of a general floating security interest – is likely to foster access to credit and assist in reducing default risk for borrowers. Empirically, the introduction of non-possessory security is associated with greater availability of credit. The empirical literature on general floating security interests suggests that they may facilitate out-of-court restructurings of distressed firms.

There is an interaction between the scope of permitted security and the extent of secured creditors' ability to enforce against their collateral: stronger enforcement powers are associated with greater willingness to lend. It appears desirable to permit secured creditors to enforce effectively even on the insolvency of the debtor, in circumstances where there is no going concern surplus to be realised. Even where a going concern surplus exists in insolvency, enforcement by a single secured creditor may achieve similar outcomes to a more collectivised process.

Finally, there are potentially important, but seldom analysed, trade-offs between the mechanisms used to facilitate the discovery by third parties of existing security interests and the extent to which debtors and creditors are able to customise and innovate regarding the terms of their security. Whilst our understanding of these trade-offs is not yet supported by any empirical work, a plausible *a priori* case can be made for reliance on a generic registration mechanism – that is, a system that does not attempt to segment the form of the registration obligation according to the type of security interest involved. This is likely to be particularly beneficial in circumstances where, as within the EU, the parties who may deal with a debtor have heterogeneous expectations as to the types of security interest that may be encountered.

The Law and Economics Debate About Secured Lending: Lessons For European Lawmaking?

Commentary

by

Hans-Bernd Schäfer*

John Armour's paper is an informative and highly readable survey on the law and economics of secured credit. The first part concentrates on the scope of permissible collateral, the efficacy of enforcement, the priority treatment of security in insolvency, and the way in which third parties are assisted in discovering that security has been granted. The second part deals with the scope of collateral over which security may be taken, the extent to which secured credit gives more power of enforcement, the extent to which secured credit is accorded priority over unsecured credit, and the manner in which efforts are made to bring the existence of security to the attention of third parties.

The author convincingly rejects the signalling theory of secured credit. According to this theory, a debtor who offers a pledge demonstrates the seriousness of his commitment to the creditor. Armour's paper shows in a persuasive way that this is not in line with economic reasoning and that, on the contrary, the debtor's advantage from offering a pledge increases with the probability of insolvency. The author proceeds with several examples of external effects and cross-subsidisation of credits in unsecured credit markets which can be alleviated by secured credits. I took particular interest in the author's description of general security and the finding in the literature that a general security and this type of secured credits lead to more informal workouts and less insolvencies as well as to better access to credit for small businesses. In Germany, the general security is usually not an option. This adjudication might be questionable in the light of such findings.

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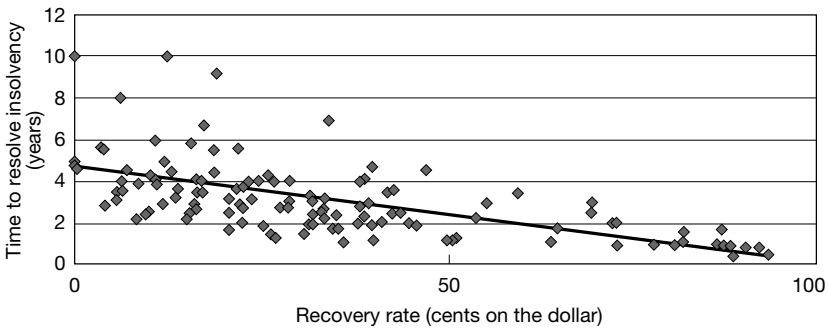
I. would like to add some extensions to the survey

1. The value of secured credit is dependent on the efficiency of the bankruptcy procedure. In many countries, the bankruptcy procedure leads to an almost total depletion of the firm's assets, which leaves both unsecured and secured creditors with a high loss.

In the plot diagram below the reader can see a close correlation between the recovery rate in a bankruptcy procedure and the time to resolve insolvency. The recovery rate includes secured and unsecured credits, as well as state claims and claims from employees. A lengthy bankruptcy procedure usually leads to a depletion of assets. In most countries with short procedures the recovery rate is often between 80 and 90 %, whereas in countries with longer periods of 8 to 10 years, it tends to be between 0 and 15 %. In such cases, even secured credit is of little value for the creditor.

Relationship between the time to resolve insolvency and the recovery rate, 2004



Source: World Bank, Doing Business Report 2007; World Development Indicators 2006, 126 countries

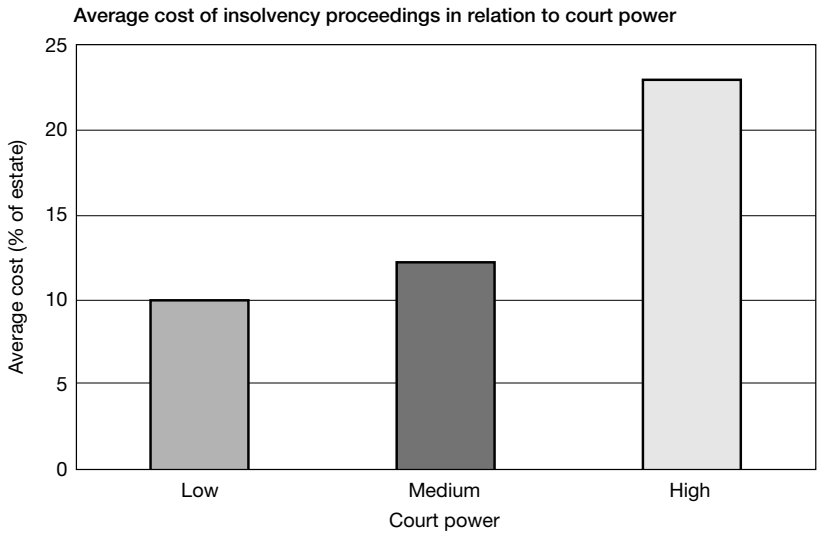
2. The table below lists some examples of countries in which the bankruptcy procedure may destroy all the beneficial effects of substantive laws of securing debts. The recovery rate is so low that in these countries, such as India or Indonesia, most creditors try to avoid the bankruptcy procedure at almost any price if that helps them to collect anything before the bankruptcy procedure. By contrast, in countries with a well-functioning bankruptcy procedure like Japan, Singapore, Norway, Taiwan or Canada, the company's assets are preserved to the benefit especially of the secured creditors.

Recovery rates in insolvency proceedings (cents on the dollar)

Japan	92.7	Congo, Dem. Rep.	4.9	China	31.5
Ireland	87.9	Central African Republic	0.0	Mexico	63.2
Singapore	91.3	Haiti	4.0	India	13.0
Taiwan	89.5	Micronesia	3.1	Philippines	4.0
Norway	91.1	Philippines	4.0	Indonesia	11.8
Canada	89.3	Angola	2.0	Brazil	12.1
Finland	89.1	Zimbabwe	0.1	Argentina	36.2
Belgium	86.4	Chad	0.0	Nigeria	32.1
Netherlands	86.3	Eritrea	0.0	South Africa	34.4
United Kingdom	85.2	Laos	0.0	Russia	28.7
Germany	53.1	France	48.0	Italy	39.7

Source: World Bank (2007) Doing Business, Statistical Appendix.

3. Court power in the insolvency procedure is another source of further depletion of assets. Judges and trustees appointed by the courts have no strong incentives to keep the costs of the proceedings low. Especially countries in the French legal tradition have high court power indices associated with high costs of the procedure.



Source: World Bank, Doing Business 2004, 74

4. Not only the length of the bankruptcy procedure has unintended consequences on the value of secured credits, but also the rights of the non-secured creditors. Countries whose bankruptcy law is in the French tradition usually have the weakest protection of secured creditors and protect unsecured at the expense of secured creditors. This depresses collateral and mortgage values. Creditors ask for a higher collateral for a given loan value. It also leads to a cross subsidisation of unsecured by secured creditors. This makes secured credits too expensive and unsecured credits too cheap. However, this is not the only unintended consequence. It also distorts incentives for the secured creditors for the following reason: If bankruptcy law protects unsecured creditors at the expense of secured creditors, the value of the collateral is worth more outside the bankruptcy procedure than inside the bankruptcy procedure. Assume, for instance, that a secured creditor can recover 100% of his loan before the bankruptcy procedure by a forced sale of the collateral, but only 50% in the procedure. This provides a high incentive for every creditor to monitor the debtor very closely in order to get a private workout before the debtor falls into financial distress. Creditors profit from being able to execute before the bankruptcy procedure is opened. They therefore have an incentive to invest up to 50 % of the credit sum into monitoring costs, which is socially wasteful. This wasteful incentive is destroyed if secured credits are worth the same before and after the bankruptcy procedure is opened.

5. John Armour has pointed out that the use of a pledge causes costs to the debtor. It might be added that these costs are for the most part dependent on substantive property law. If property law is well designed, these costs can be kept at a minimum. Property law which requires, for instance, possession of the creditor is counter-productive in most cases. Usually, the borrower needs the pledged assets to run his business, which excludes possession by the lender. If property law does not allow the borrower to sell assets, this can create problems for using work in progress or raw materials as collateral. However, many legal orders, including the German legal order, have found quite efficient means of overcoming these problems by flexible methods to extend the collateral from raw materials to work in progress, from work in progress to finished goods, and from finished goods to financial assets. Especially in a country like Germany, whose financial system has traditionally been bank-based, banks have found intelligent ways to use almost all assets of the corporation as collateral without causing large costs of disruption or of running the business of a company.

However, there are many countries in which these problems have not yet been solved and where property law is much too inflexible, thus causing high costs for the company to pledge away assets. This can lead to a situation in which it is almost impossible to borrow on pledge and to enforce collaterals, especially for movables. This is a particular problem for countries in transition and for

developing countries. Fleisig[1] provides some illustrative examples on the problems of using movable property as collateral in circumstances where property law is not well developed and not adjusted to the requirements of credit markets. Suppose a bank wants to lend against a herd of cattle. Here, the first problem is to define the pledged asset properly and cost-efficiently for the purpose of repossession. In many legal orders, each pledged piece of cattle must be put on a closed list and must be identified for instance by name or a tattooed number, as in Uruguay. As the individual pieces of cattle in the herd change continuously, the value of the collateral diminishes quickly because the lender can repossess only the cattle on the list. To preserve the value of the collateral, the list must be updated frequently. This reduces the value of the asset as collateral. Uruguay is a major exporter of wool, which is especially valuable as collateral. In one case, a bank gave a credit and renewed it for years to finance the stock of a particular warehouse that was filled with the debtor's wool. But as the pledged wool had been exported and the warehouse was filled with new wool, the court decided that the pledged wool was gone and the creditor had to write off the debt. Legal practice in Canada and in the United States is exactly the opposite. According to Fleisig,[2] a credit contract which consists of an agreement on pledging cattle on a particular piece of land is a valid contract in these jurisdictions.

Problems of overly formalistic property law in conjunction with difficulties to repossess the collateral leads to a situation in which large parts of the movable assets of companies cannot be used as pledge at all, so that banks must insist on mortgage loans. Therefore, in large parts of developing countries and countries in transition, movable assets remain dead capital in the sense that they cannot mobilise secured credit.

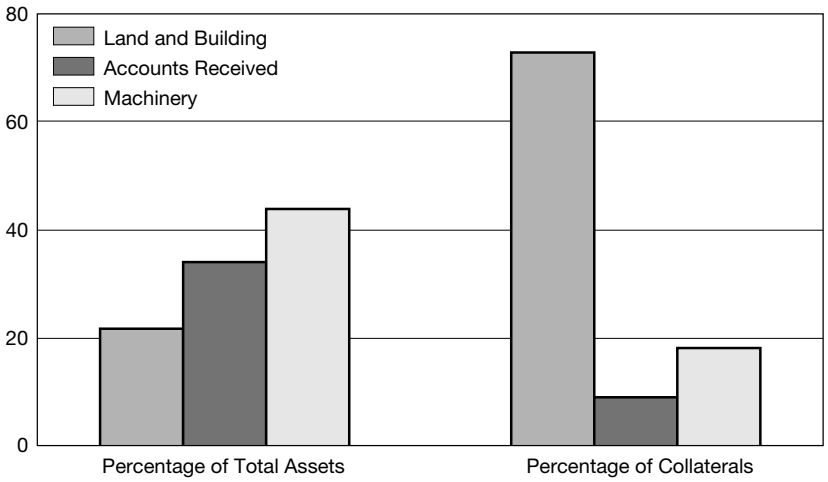
The diagram below illustrates this. In 60 developing and transition countries, more than 70 % of all bank credits are based on mortgage loans and on land and buildings, and only 25 % on accounts and machinery, whereas the share of land and buildings in total assets amounts only to 20 %. This shows that property law that puts too many formalistic restrictions on the definition of what a pledged asset is can become dysfunctional and render large parts of a company's assets into dead capital.[3]

1 H Fleisig, 'Secured Transactions. The Power of Collateral' (1996) Finance and Development Vol. 33 (2), 44–46.

2 Fleisig, op. cit.

3 Safavian/Fleisig/Steinbucks, *Unlocking Dead Capital, How Reforming Collateral Laws Improves Access to Finance, Public Policy for the Private Sector*, World Bank, 2006.

Distribution of Assets and Collaterals in 60 developing countries
(Data from Safavian/Fleisig/Steinbuks, 2006)



6. The author thinks that non-possessed security interest must be or should be registered. This seems to be the general view in the Anglo-Saxon world. Many countries use registers for all kind of pledged assets. The European Bank for Reconstruction and Development is now propagating registers for movables and introducing them in many countries of transition in Eastern Europe.[4] However, I am not fully convinced that the establishment of registers is necessary. In Germany, no such registers exist. Of course, this leads to problems of priority and of defining who the rightful secured creditor is if an asset is pledged more than once. But these problems have been solved by judge-made rules. Conflicts between banks giving a loan against a non possessed pledge and manufacturers giving a credit against retention of ownership titles could be solved, and the costs of a register can be saved. The value of this argument is, of course, dependent on the total costs of setting up, maintaining and using the register. In the age of internet these costs might be much lower than they used to be in the past.

4 EBRD Secured Transactions, Past and Current Projects (2005) <http://www.ebrd.com/country/sector/law/st/new/projects/index.htm (last visited Nov. 2007)>.

Secured Credit and the Internal Market: The Fundamental Freedoms and the EU's Mandate for Legislation

by

Wulf-Henning Roth*

Table of Contents

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I. Introduction

The unhampered movement of persons, goods, services and capital guaranteed by the fundamental freedoms of the EC-Treaty constitutes the very essence of the internal market (EC art 14 sec 2). Taken this as the starting point, it may appear somewhat surprising that with regard to security rights we seem to live in quite a different world: A security right that has been validly created with regard to a movable under the law of one Member State runs the risk of being wiped out in the very moment that the movable is exported to another Member State. Since more than forty years this issue has been discussed inside[1] and outside[2] the European institutions, and except for art 4 of the late payment directive of 2000[3] not much has been achieved. In this paper we will discuss whether and to what extent the fundamental freedoms of the EC-Treaty may provide some help, and whether the Community is competent to legislate to overcome any diversities between the national laws dealing with security rights.

1 See for an overview of European initiatives Eva-Maria Kieninger, *Mobiliarsicherheiten im Europäischen Binnenmarkt*, 1996, 216, 221.

2 Eg Ulrich Drobnig, 'Mobiliarsicherheiten im Internationalen Wirtschaftsverkehr' (1974) 38 RabelsZ 468; Karl Kreuzer, 'Gutachtliche Stellungnahme zum Referentenentwurf eines Gesetzes zur Ergänzung des Internationalen Privatrechts (Außervertragliche Schuldverhältnisse und Sachen) – Sachenrechtliche Bestimmungen', in: Dieter Henrich (ed), *Vorschläge und Gutachten zur Reform des deutschen internationalen Sachen- und Immaterialgüterrechts*, 1991, 37; Eva-Maria Kieninger (n 1); Peter von Wilmowsky, *Europäisches Kreditsicherungsrecht*, 1996; Jacobien W. Rutgers, *International Reservation of Title Clauses*, 1999; Sylvia Kaufhold, *Internationales und europäisches Mobiliarsicherungsrecht*, 1999; Thilo Rott, *Vereinheitlichung des Rechts der Mobiliarsicherheiten*, 2000; Christel Bourbon-Seclet, 'Cross-border Security Interests in Movable Property: An Attempt at Rationalising the International Patchwork' (2005) J.I.B.L.Rev 419, 501; Peter Wohlgemuth, *Vergemeinschaftung des Mobiliarsicherheitenrechts*, 2005; Ulrich Drobnig/Henk J Snijders/Erik-Jan Zippro (eds), *Divergences of Property Law – an Obstacle to the Internal Market?* 2006; for a discussion of the issues also with regard to Swiss and US law: Barbara Graham-Siegenthaler, *Kreditsicherungsrechte im internationalen Rechtsverkehr*, 2006.

3 Art 4 of Council Directive (EC) 2000/35 on combating late payment in commercial transactions, [2000] O. J. L 200/35, calls for recognition of a proprietary interest based on retention of title, however without any meaningful harmonisation.

We will address the topic in six consecutive steps: First, we will recall the reasons for any existing problems (below II.), followed, secondly, by a discussion whether the fundamental freedoms of the EC-Treaty are relevant at all (below III.) and, if so, which freedoms are relevant (below IV.). In a forth step, we will outline the justifications available for Member State measures inhibiting the freedoms, and the relevant standards that have to be applied (below V.). Fifthly, we will examine the respective provisions in the EC-Treaty that may give the Community a competence to legislate in the field of security interests (below VI.). The last section will summarize the main findings (below VII.).

II. The problem

The substantive law provisions of the EC Member States diverge considerably with regard to security rights in movable and immovable property.[4] A fiduciary transfer of property without a transfer of possession is given full effect also vis-à-vis third persons in some States, but not in others. Reservation of title, which may be regarded as a security interest,[5] is known in the law of all Member States. It has to be recognized at least *inter partes* on behalf of art 4 of the late payment directive,[6] but some Member States require some kind of documentary proof in writing (and Switzerland, a non-Member-State, its registration).[7] Such diversities may present a burden for those players in the market who transact business on a Community-wide scale.

This kind of burden may arise in a twofold manner. As all Member States apply the *lex rei sitae* as the relevant rule of private international law, the *creation* of a security interest attached to an asset will be governed by the law of the

4 See eg Eva-Maria Kieninger (n 1) 41; Jacobien W Rutgers (n 2) 13; Peter Wohlgemuth (n 2) 58 et seq; Karl Kreuzer (ed), *Mobiliarsicherheiten – Vielfalt oder Einheit?* 1999; Eva-Maria Kieninger (ed), *Security Rights in Movable Property in European Private Law*, 2004, 6 (with further references in n 1).

5 Eg Christian von Bar/Ulrich Drobnig (eds), *The Interaction of Contract Law and Tort and Property Law in Europe*, 2004, 332 No. 502.

6 The ECJ has interpreted art 4 in a restrictive fashion, leaving it to the applicable national law of property to determine the conditions under which a retention of title may be validly agreed upon and whether the title may exert consequences vis-à-vis third parties; ECJ 26 October 2006, C-302/05, Commission ./. Italy, para 28, 30. With regard to art 4 see also Eva-Maria Kieninger, 'Der Eigentumsvorbehalt in der Verzugsrichtlinie – Chronik einer verpassten Chance', in: *Aufbruch nach Europa – 75 Jahre Max-Planck-Institut für Privatrecht*, 2001, 151.

7 See Eva-Maria Kieninger (n 1) 41; Sylvia Kaufhold (n 2) 36; Andreas Schlüter, 'Der Eigentumsvorbehalt im europäischen und internationalen Recht' (2001) IHR 141; Giorgio Monti/Gilles Nejman/Wolf J Reuter, 'The future of reservation of title clauses in the European Community' (1997) 46 I.C.L.Qu. 866.

Member State where the asset is located. I.e. in case the assets securing a loan are located in 27 Member States the creation of the respective security rights would require the application of the laws of 27 jurisdictions: Companies with business operations in different Member States have to adapt their credit business to as many jurisdictions as are involved in the course of their business. This burden could surely be reduced if the parties to the transactions were competent to choose the applicable law for the creation of a security right irrespective of where the movable or immovable is located.

A far more dramatic consequence may arise from the transborder movement of an asset. Under the *situs* rule as applied in some Member States such a transborder movement will cause a change in the applicable law (*Statutenwechsel*): A security right that has been created according to the law of State A (on the basis of the *lex rei sitae*) will upon moving the asset to State B be governed by the law of State B. As a general rule, a property right and its acquisition under the law of State A will be recognized as such in State B (with reference to the law of State A). Though the applicable conflict-of-laws rule – the *situs* rule – is the same in both States, diversities of the substantive law of property may, nevertheless, lead to potentially disastrous consequences as far as security rights are concerned: A non-possessory pledge which has been validly created according to the law of Member State A will extinguish when the pledged asset is moved to Member State B in case that the substantive law of B does not recognize such a non-possessory pledge. A reservation of title validly agreed under the law of Member State A with effect vis-à-vis third parties is of little value if, after the asset has been moved to State B, the reservation of title would only be effective *inter partes* under the law of State B. Creditors are thereby exposed to a specific risk in international trade, created by differences in the substantive rules concerning security rights and the change in the applicable law, set forth by the *situs* rule.[8]

Private international law may basically offer two ways to alleviate (if not to solve) this problem: One opinion argues that a *choice of the applicable law* would solve the problem.[9] However, until today the Member States still deem the *lex rei sitae* as a mandatory conflict-of-laws rule. Likewise, the parties' freedom to chose the applicable law is limited to few cases, eg for *res in transitu*. In general, the law of the state of the *situs* shall determine the legal status of the security, the relation

8 Christian von Bar/Ulrich Drobnig (eds) (n 5) 342 No. 525; Sylvia Kaufhold (n 2) 80; Thilo Rott (n 2) 6; Peter Wohlgemuth (n 2) 58; an extensive analysis is offered by Barbara Graham-Siegenthaler (n 2) 47 (Switzerland), 241 (Italy), 334 (France), 450 (England). It goes without saying that diversities in the classification of a security right may cause further problems.

9 Hans Stoll, 'Rechtskollisionen beim Gebietswechsel beweglicher Sachen' (1974) 38 RabelsZ 450; Peter von Wilmowsky (n 2) 151 (parties' autonomy being, however, supplemented by mandatory rules of the *lex debitoris* or the *lex rei sitae* in favor of the protection of creditors); Jacobien W. Rutgers (n 2) 205.

towards third persons (creditors), and the relationship among conflicting security rights created under the laws of different Member States (eg the principle of priority).[10]

On the other hand, applying the so called method of *transposition* may provide a solution:[11] A security right that has been attached to a moveable under the law of State A will, when the asset is moved to State B, (accompanied by a change of the law applicable; *Statutenwechsel*) be transposed into a functional equivalent security right known to the law of State B. By way of assimilation ("transposition") the security right will not extinguish, but rather be recognized on the basis and within the framework of the new *situs* regime. However, it goes without saying that such a transposition will only be effectuated by State B if the security right of State A can be transposed into a functional equivalent legal institution of the law of State B: In case the law of a state does not provide for non-possessory pledges at all, it will not accept their transposition from a foreign law.

In a recent study it has been shown that the Member States differ widely in their approach to the recognition of security rights set up according to foreign law, and their willingness to use the instrument of transposition. In essence, the Member States differ in their basic attitude towards a *non-possessory* pledge as well as *non-possessory* retention or transfer of title.[12]

III. Are the fundamental freedoms relevant?

1. Preliminary observations

At the outset, we may ask whether and why the fundamental freedoms – free movement of goods (EC artt 28–30) and free movement of capital (EC artt 56–58) as the most important freedoms – shall be relevant at all. After all, diversity between substantive private law rules as well as conflict-of-laws rules may be considered as an inherent feature of any quasi-federal entity that is based on decentralized decision-making. Competitive federalism[13] builds on the diversity

10 Eva-Maria Kieninger, 'Securities in Movable Property within the Common Market' (1996) 4 Eur. Rev. Priv. Law 41, 50–51.

11 For German law see Sylvia Kaufhold (n 2) 80; Barbara Graham-Siegenthaler (n 2) 138; Christiane Wendehorst, in Hans Jürgen Sonnenberger (ed), *Münchener Kommentar zum Bürgerlichen Gesetzbuch*, vol. 10, 4th edn 2006, Art 43 EGBGB No. 147–154.

12 See Christian von Bar/Ulrich Drobnig (eds) (n 5) 342 No. 524–528.

13 Eg Eva-Maria Kieninger, *Wettbewerb der Privatrechtsordnungen im Europäischen Binnenmarkt*, 2002; Markus Müller, *Systemwettbewerb, Harmonisierung und Wettbewerbsverzerrung*, 2000; Simon Deakin, 'Legal Diversity and Regulatory Competition: Which Model for Europe?' (2006) 12 European L.J. 440.

of laws in the Member States and, by necessity, accepts the transaction costs and other disadvantages that may ensue from such diversity. In case that the negative consequences of diversity between legal rules become a problem, decentralized decision making may be replaced by legislation on the federal level, – in the EC by harmonisation on the basis eg of EC art 95. Given this Community competence for harmonisation, it is submitted that the transaction costs (eg for gathering information on unknown legal provisions) created by the diversity between national laws may be removed by harmonisation, but cannot, as such, be a sufficient reason for the fundamental freedoms to be applied:[14] In contrast, the *telos* of the fundamental freedoms should not be seen as to set limits to the diversity of rules, but rather to secure and to promote the unimpeded and undistorted *access* for traders and consumers *to the markets* of all Member States; such a view, indeed, also seems to be the basis of the jurisprudence of the Community Courts with regard to the fundamental freedoms.[15]

If it is not the diversity between legal rules as such but the potential *market access* impeding effect of rules that should count, it has, nevertheless, to be acknowledged that access to the markets of the Member States is inherently impeded because legal provisions, even if formulated in a non-discriminatory fashion, often just reflect local/national problems, interests and preferences, without giving due weight to the exigencies of the internal market (and access to the market).[16] Viewed in this perspective, the interpretation of the fundamental freedoms by the European Court of Justice ("ECJ") may be regarded as an attempt to counterbalance the inherently one-sided value judgments of national legislators, and to put the Member States under the obligation to *adapt* their national law to the exigencies of an unimpeded and undistorted access to their markets and territory.[17]

The treatment of motor vehicles may serve as an example. EC artt 28 and 29 grant an unwritten transit right; the provisions regarding free movement of goods

14 See Stephen Weatherill, 'Diversity between National Laws in the Internal Market', in: Ulrich Drobnig/Henk J Snijders/Erik-Jan Zippro (eds) (n 2) 131, 134; Wulf-Henning Roth, 'Die Grundfreiheiten und das Internationale Privatrecht', in: *Gedächtnisschrift für Alexander Lüderitz*, 2000, 635, 639; Katrin Schilling, *Binnenmarktkollisionsrecht*, 2006, 228.

15 The stress on *market access* runs through the case law of the ECJ and the opinions of the Advocats General; eg ECJ 24 November 1993, C-267 and 268/91, Keck and Mithouard, ECR 1993, I-6097 para 17; AG Léger, C-309/99, 10 July 2001, Wouters, ECR 2002, I-1577, 1579 para 244; AG Kokott, 14 December 2006, C-142/05, Aklagaren, para 66 and n 31.

16 See Wulf-Henning Roth, *Freier Warenverkehr und staatliche Regelungsgewalt in einem Gemeinsamen Markt*, 1977, 56–57.

17 ECJ 13 December 2005, C-411/03, SEVIC Systems, ECR 2005, I-10805 para 21, 30 (arguing with discrimination); see also Wulf-Henning Roth, 'Die Freiheiten des EG-Vertrages und das nationale Privatrecht' (1994) ZEuP 5, 20–21.

will avoid any restrictions on the interstate transport of goods by vehicles.[18] Assuming a fiduciary transfer of a motor vehicle effected in Germany, and assuming further that Austrian law does not recognize such a *security interest* in the vehicle,[19] the vehicle *de facto* cannot be used to transport goods from Germany to Hungary. This effect certainly qualifies as a *measure of equivalent effect* under EC art 28. Likewise, EC art 28 will also apply if a transit Member State recognizes a non-possessory pledge for goods in transit only in case the retention of title has been *registered*. As a consequence, a seller should avoid a transit State that follows such a rule. In both cases the application of the national rule impedes the access to the market by not considering the needs of the internal market.

2. Private substantive law

Though there is not much case law of the ECJ,[20] it may safely be assumed that the freedoms of the EC apply to provisions of private substantive law if they have an impeding effect on the interstate movement of capital or goods.[21] Such an effect is likely to arise when private law provisions of a mandatory character make the import of goods or services less attractive, eg contract law provisions influencing the legal content of a credit or insurance product.[22] Mandatory provisions may have the consequence that certain services that are legally offered in the state of origin cannot or will not be distributed in the state of destination. Viewed in this perspective, we may assume that mandatory rules of national property

18 ECJ 12 July 1973, Case 2/73, ECR 1973, 865 para 7; ECJ 16 March 1983, Case 266/81, SIOT, ECR 1983, 731 para 17; ECJ 4 October 1991, C-367/89, Aimé Richardt, ECR 1991, I-4621 para 14; ECJ 9 December 1997, C-265/95, Commission v. France, ECR 1997, I-6959 para 53; ECJ 11 May 1999, C-350/97, Wilfried Monsees, ECR 1999, I-2921 para 23; ECJ 12 June 2003, C-112/00, Schmidberger, ECR 2003, I-5659 para 61.

19 OGH 14.12.1983, JBl. 1984, 550; see also Christian von Bar/Ulrich Drobnig (n 5) 343 No. 525 n 130.

20 But see ECJ 24 January 1991, C-339/89, Alsthom Atlantique, ECR 1991, I-107; ECJ 13 October 1993, C-93/92, CMC Motorradcenter, ECR 1993, I-5009.

21 See the fundamental study by Ernst Steindorff, *EG-Vertrag und Privatrecht*, 1996; in accord Apostolos Gkoutzinis, 'Free movement of services in the EC Treaty and the law of contractual obligations relating to banking and financial services' (2004) 41 Common Market Law Rev. 119, 129; Wulf-Henning Roth (n 17) 5; Martin Franzen, *Privatrechtsangleichung durch die Europäische Gemeinschaft*, 1999, 118; Peter von Wilmowsky (n 2) 32; Torsten Körber, *Grundfreiheiten und Privatrecht*, 2004, 399; Oliver Remien, *Zwingendes Vertragsrecht und Grundfreiheiten des EG-Vertrages*, 2003, 178.

22 ECJ 5 October 2004, C-442/02, CaixaBank France, ECR 2004, I-8961 para 11–16; Thomas Wernicke, *Privates Bankvertragsrecht im EG-Binnenmarkt*, 1996; Wulf-Henning Roth, 'Europäisches Versicherungsrecht, No. 31–44', in: Heinrich Honsell (ed), *Berliner Kommentar zum Versicherungsvertragsgesetz*, 1999.

law, if applied to imported goods, may work as an impediment on the interstate movement of goods. This effect seems beyond doubt in a case where the law of the state of the new *situs* does not recognize a security right which has been created on the basis of the law of the former *situs*.

In case a mandatory rule of private substantive law conflicts with one of the freedoms of the EC Treaty the consequences may vary depending on the relevant conflict: The concerned rule may either be unapplied or adjusted in order to evade the conflict. As we have already pointed out,[23] the freedoms may create a duty to establish a rule which complies with international needs and secures access to the market (eg by creating a so-called *multistate* substantive rule;[24] *internationale Sachnorm*[25]). For example, in the field of international corporate law the freedom of foundation (Artt. 43, 48 EC) requires Member States to provide legal rules that allow for a transnational merger[26] or for a transnational transformation (*Umwandlung*). Applying these rules on security rights, national property law may have to develop ways and means to *transpose* an unknown security right established under another legal system into an equivalent national security right.

3. Private international law

The relationship between the fundamental freedoms of the EC-Treaty and (national) private international law has been the object of an intensive debate starting[27] in the early 1990's.[28] Due to the absence of any relevant case law of the

23 See the text above following n 15.

24 Arthur Taylor van Mehren, 'Special substantive rules for multistate problems: Their role and significance in contemporary choice of law methodology' (1974/75) 88 Harvard L. Rev. 346, 359; Arthur Taylor van Mehren/Donald Trautman, *The Law of Multistate Problems*, 1965, 215, 313.

25 Ernst Steindorff, *Sachnormen im internationalen Privatrecht*, 1958.

26 ECJ 13 December 2005, C-411/03, SEVIC Systems, ECR 2005, I-10805 para 21, 30 (arguing with discrimination); Marcus Lutter/Tim Drygala, '§ 1 No. 14–18', in: Marcus Lutter/Martin Winter (eds), *Umwandlungsgesetz – Kommentar*, 3rd edn 2004; Wulf-Henning Roth, 'Recognition of Foreign Companies in *Siège Réel* Countries: A German Perspective', in: Jan Wouters/Hildegard Schneider (eds), *Current Issues of Cross-Border Establishment of Companies in the European Union*, 1995, 29, 37.

27 In fact, in the late 1960's it was Ulrich Drobnig who extensively discussed the implications of the prohibition to discriminate on the basis of nationality for private international law; see Ulrich Drobnig, 'Conflict of Laws and the European Economic Community' (1967) 15 Am.J.Comp.L. 204; Ulrich Drobnig, 'Verstößt das Staatsangehörigkeitsprinzip gegen das Diskriminierungsverbot des EWG-Vertrages?' (1970) RabelsZ 34 636. For a résumée in the 1980's see Wulf-Henning Roth, *Internationales Versicherungsvertragsrecht*, 1985, 691.

28 For a recent analysis of the discussion see Torsten Körber (n 22) 435 (with further references); see further Marc Fallon, 'Libertés communautaires et règles de conflit de lois', in: Angelika Fuchs/Horatia Muir Watt/Étienne Pataut (eds), *Les conflits de lois*

ECJ, the debate until today has been rather speculative. Nevertheless, the issue is, as we will see, of great importance for our topic.

With regard to the relationship between the fundamental freedoms and national conflict-of-laws rules the main positions taken in the discussion are the following:

a) One position argues that the fundamental freedoms have to be regarded as *disguised ("hidden") conflict-of-laws rules*: the "state of origin principle" developed in the *Cassis* case-law[29] should be regarded as a conflict-of-laws rule insofar as the state of destination must either apply the law of the state of origin in order to avoid any restrictions on interstate trade,[30] or, at least, apply it if it is more favourable to the interstate movement of goods and services than the law of the state of destination.[31] However, the ECJ has clearly rejected the idea considering the state-of-origin principle as part of primary EC law[32]; moreover, the ECJ has held the state-of-origin principle as discriminating under EC art 12.[33] Despite this case law, the effective application of the freedoms may oblige the Member States to *recognize* legal rights, institutions and persons that have been legally created and established under the law of another Member State.[34] The *Centros*, *Übersee-*

et le système juridique communautaire, 2004; Hans Jürgen Sonnenberger, 'Einl. IPR No. 171–197', in: *Münchener Kommentar zum Bürgerlichen Gesetzbuch*, ed by Hans Jürgen Sonnenberger, vol. 10, 4th ed 2006; Katrin Schilling (n 14) 163; Wulf-Henning Roth (n 14) 635; Jacobien W Rutgers (n 2) 167; Johannes Fetsch, *Eingriffsnormen und EG-Vertrag*, 2002, 126.

29 ECJ 30 January 1979, Case 120/78, Rewe-Zentrale ("Cassis de Dijon"), ECR 1979, 649 para 14 ("There is therefore no valid reason why, provided that they have been lawfully produced and marketed in one of the Member States, alcoholic beverages should not be introduced into any other Member State … .").

30 Thomas Wernicke (n 22) 96 et seq; Wolfgang Drasch, *Das Herkunftslandprinzip im internationalen Privatrecht*, 1997, 362 et seq.

31 Jürgen Basedow, 'Der kollisionsrechtliche Gehalt der Produktfreiheiten im europäischen Binnenmarkt: favor offerentis' (1995) 59 RabelsZ 1; *contra* Peter von Wilmowsky (n 2) 52; Stefan Bruinier, *Der Einfluss der Grundfreiheiten auf das Internationale Privatrecht*, 2003, 39; Hans Jürgen Sonnenberger (n 11) Einl. IPR No. 164; Christoph Ohler, *Die Kollisionsordnung des Allgemeinen Verwaltungsrechts*, 2005, 67; Christiane Wendehorst, 'Kollisionsnormen im primären Europarecht?' in: *Festschrift für Andreas Heldrich*, 2005, 1071, 1086; Heinz-Peter Mansel, 'Anerkennung als Grundprinzip des Europäischen Rechtsraum' (2006) 70 RabelsZ 651, 672; Wulf-Henning Roth, 'Methoden der Rechtsfindung und Rechtsanwendung im Europäischen Kollisionsrecht' (2006) IPRax 338, 339.

32 ECJ 13 May 1997, C-233/94, Germany ./. European Parliament, ECR 1997, I-2405 para 64; Torsten Körber (n 21) 28–29.

33 ECJ 30 June 2005, C-28/04, Tod's SpA, ECR 2005, I-5781 para 27. See already ECJ 20 April 1983, Case 59/82, Weinvertriebs-GmbH, ECR 1983, 1217 para 8.

34 Wulf-Henning Roth (n 31) 340.

ring and *Inspire Art* judgments[35] may stand for this proposition which, in the following, will exert some influence on the discussion of our topic.

Another approach contends that the fundamental freedoms call for *party autonomy* as a conflicts rule arguing that the denial of parties' autonomy would amount to a burden on the interstate business of any trader.[36] This view would have far-reaching consequences. Certainly, as far as the *situs* rule works as a restriction on interstate trade it must be justified by mandatory requirements of the public interest as developed and accepted by the ECJ in its case law.[37] However, the argument in favour of party autonomy goes far beyond that. It is based on the (rather loosely argued) assumption that mere diversities between national laws and the costs associated with the application of different legal orders constitute a burden on interstate trade and therefore amount to a relevant restriction of the fundamental freedoms. As pointed out yet an infringement of the fundamental freedoms requires more than simply a burden on interstate commerce created by the diversity between legal provisions: It has to be shown that access to the market of a Member State is likely to be impeded.[38] Another question (which is not discussed here) is whether or not parties' autonomy as a conflict-of-laws rule should be introduced into secondary Community law by way of harmonisation.

b) According to another position[39] freedoms do not influence the choice-of-law process at all. Conflict-of-laws rules should rather be regarded as *neutral* (or indifferent), whereas mandatory rules of substantive law may exert an impediment on interstate commerce and thereby conflict with the fundamental freedoms. It is suggested that this position somewhat underestimates the role played by choice-of-law rules: Eg a choice-of-law rule that is based on the state-of-origin principle cannot be regarded as "neutral" if the application of this rule together with the substantive law of the State of origin leads to a heavier burden and therefore exerts a discriminatory effect for imported products.

35 ECJ 9 March 1999, C-212/97, Centros, ECR 1999, I-1459; ECJ 5 November 2002, C-208/00, Überseering, ECR 2002, I-9919; ECJ 30 September, C-167/01, Inspire Art, ECR 2003, I-10155.

36 Peter von Wilmowsky (n 2) 43–46; party autonomy shall be supplemented by mandatory provisions of the *lex debitoris* or the *lex rei sitae* for the protection of creditors (151).

37 See eg Wyatt/Dashwood, *European Union Law*, 5th ed 2006, 579; Paul Craig/Gráinne de Búrca, *EU Law*, 3rd ed 2003, 659; Wulf-Henning Roth, 'E.I. No. 99–108, No. 199–209', in: Manfred Dauses (ed), *Handbuch des EU-Wirtschaftsrechts*, vol. 1, 17th ed 2006.

38 Text above following n 13.

39 Christian Kohler, 'La Cour de Justice des Communautés européennes et le droit international privé', in: Trav. Com. francais d.p.i. 1993–1994, 1996, 71, 75; Olaf Langner, 'Das Kaufrecht auf dem Prüfstand der Warenverkehrsfreiheit' (2001) 65 RabelsZ 222, 227; Harry Duintjer Tebbens, 'Les conflits de lois en matière de publicité déloyale à l'épreuve du droit communautaire' (1994) 83 Rev.crit.d.i.p. 451, 476 et seq.

c) A third position[40] argues that the relevant infringement of the fundamental freedoms, at least in the ordinary case, results from a *combined* application of a (mandatory) conflict-of-laws rule and a (mandatory) provision of substantive law. Both categories of rules have to be analysed together in order to determine their restrictive effect on interstate commerce: A rule of substantive law will only apply upon a conflict-of-laws rule were calling for its application. And a conflict-of laws rule as such will not qualify as burden unless it is accompanied by a provision of substantive law. However, a deeper analysis reveals two different scenarios: (i) there are situations in which only a substantive law provision may cause a relevant impediment (eg if it discriminates against out-of-state goods or services), which impediment may easily be removed by amending this provision (without changing the relevant conflicts rule); (ii) there might also be situations in which conflict-of-laws rules prescribe an overly broad (geographic) scope of application for a relevant provision of substantive law,[41] or in which the applicable conflict-of-laws rule as such is written in a discriminatory fashion.[42]

IV. Which freedoms are relevant?

For the following analysis it may be helpful to distinguish between the creation of a security right on the one hand, and the transborder movement of an asset to which a security right has been attached on the other hand.

1. Creation of security rights

The *situs* rule calls for the (mandatory) application of the law of the state where the movable is located for deciding the question whether a security right has been validly *created* by the agreement of the parties.[43]

40 Johannes Fetsch (n 28) 127; Eva-Maria Kieninger (n 1) 243; Jan Wouters, 'Conflict of Laws and the Single Market for Financial Services' (1997) MJ 4, 161, 284, 290; Wulf-Henning Roth (n 14) 635, 644; Katrin Schilling (n 14) 163; Horatia Muir Watt, 'Integration and Diversity: The Conflict of Laws as a Regulatory Tool', in: Fabrizio Cafaggi (ed), *The Institutional Framework of European Private Law*, 2006, 107, at 120.

41 See eg the Dutch rule on cold calling discussed in ECJ 10 May 1995, C-384/93, Alpine Investments, ECR 1995, I-1141; Wulf-Henning Roth (n 31) 341.

42 See for a conflicts rule in the field of product liability: Wulf-Henning Roth (n 14) 635, 647.

43 A security right may be understood to be *created* if it is effective between the parties of the agreement; it may be effective also against third parties, but need not to be so; as to the prerequisites of attachment and perfection in English law see Roy Goode, *Commercial Law*, 3rd ed 2004, 633, 647.

It has been forcefully argued that (apart from the problems connected with the consecutive transborder movement of the asset; see under 2.) the *situs* rule in effect unduly burdens the conclusion of a secured interstate loan agreement between parties residing in different States, thereby restricting the freedom of capital movement (Art. 56 sec. 1 EC). The undue restriction imposed by the *situs* rule for the creation of a security right is supposed to lie in its mandatory character, excluding parties' autonomy as a conflict-of-laws rule.[44]

At the outset, it should be recalled that the scope of freedom of capital movement is very broad. The EC Treaty does not define "capital" movement as such. But the European ECJ[45] has consistently referred to the nomenclature annexed to Directive 88/361/EEC of 24 June 1988.[46] In Annex I of this Directive loans (under point XI of the nomenclature) are described as personal capital movements; sureties, other guarantees, and rights of pledge amount to capital movement in case they are granted by non-residents to residents and vice versa (point IX). A capital movement appears to exist also in case that payment of the agreed price is *deferred*, the deferment granted by the vendor to the purchaser.[47] Moreover, the transborder *creation* of any collateral in connection with a loan agreement will have to be considered as capital movement as well.

However, not every mandatory provision that influences the content of loan agreements or secured rights qualifies as a *restriction* of capital movement (EC art 56 sec. 1) that needs to be justified by the mandatory requirements. Capital movement between the Member States presupposes the existence of property law rules in the law of the Member States governing the parties' agreements: In order to *create* a security right parties are dependant on an existing private substantive law as the *infrastructure* for their transactions.[48] Freedom of capital movement would be misconceived if this freedom (like all other fundamental freedoms) were understood as a charter for liberalising national mandatory property law or the promotion of the commercial freedom of traders.[49] Whether and to what extent

44 Peter von Wilmowsky (n 2) 103.

45 Eg ECJ 28 September 2006, C-283/04, Commission ./. Netherlands, para 19.

46 Council Directive of 24 June 1988 for the implementation of Article 67 of the Treaty (88/361/EEC), O.J. 1988 L 178 5.

47 Opinion of AG La Pergola, C-222/97, Trummer and Mayer, ECR 1999, I-1663 para 9.

48 See Ernst Steindorff (n 21) 52.

49 See with regard to the free movement of goods: ECJ 24 November 1993, C-267 and 268/91, Keck and Mithouard, ECR 1993, I-6097 para 14; AG Tesauro, 27 October 1993, C-292/92, Hünermund, ECR 1993, I-6800 para 25–28; AG Fennelly, 16 September 1999, C-190/98, Volker Graf, ECR 2000, I-495 para 31–32; AG Tizzano, 25 March 2004, C-442/02, CaixaBank France, ECR 2004, I-8963 para 58–63 (to extend the application of the fundamental freedoms to regulations of economic activity as such would be "tantamount to bending the Treaty to a purpose for which it was not intended …"); AG Poiares Maduro, 30 March 2006, C-158 and 159/04, Alfa Vita, para 36–39; AG Kokott, 14 December 2006, C-142/05, Aklagaren, para 47–48.

the Member States apply mandatory rules of property law is a matter of discretion. Freedom of capital movement only comes into play when the interstate movement of capital, the *access to the market* by non-residents, is affected by restrictive measures by the state of origin or the state of destination. Consequently, freedom of capital movement is *not meant* to give the parties a right of choice to select the most appropriate legal system for the creation of a security right.[50] It is therefore submitted that the *situs* rule as a mandatory conflict-of-laws rule, as well as mandatory substantive law provisions concerning the creation of a security right, should not be regarded as "restrictions" of the freedom of capital movement as long as they do not discriminate (in law or in fact) against transborder capital movements, and as long as the provisions, if even-handedly applied, do not specifically restrict the access to the market. With regard to the creation of security rights, the *situs* rule as such does not infringe the EC-Treaty.

2 Transborder movement

The diversity of the Member States' substantive rules relating to security rights, linked with the *situs* rule as the dominating conflict-of-laws rule in the Member States, leads to major problems when assets to which secured rights have been validly attached are moved from one Member State to the other. With regard to such a movement the fundamental freedoms may come into play.

a) Free movement of goods

aa) Transit

As pointed out above in the case of a *transit transport* of goods and/or of a motor vehicle the application of the *situs* rule combined with a substantive law rule that does not recognize a valid foreign non-possessory security right (with regard to the goods or to the motor vehicle) may qualify as a restriction within the meaning of EC art 28:[51] With regard to transit situations the notion of a "measure with an equivalent effect" (EC artt 28, 29) extends to all (also even-handedly applied) provisions which tend to make the transit traffic less attractive and more costly, and which may lead the structure of transit traffic to be moved from one State to another.

50 But see Peter von Wilmowsky (n 2) 106.
51 Text at n 18.

bb) Imports

Apart from transit cases the free movement of goods may also be restricted in those cases where a movable to which a security right has validly been attached under the law of Member State A will be exported to Member State B that does not recognize the validly created security right. Such a policy of non-recognition may work as a restriction to the import of goods: If a reservation of title will not be recognized by the law of the importing state, the seller will either have to refrain from exporting to that state, or he will have to use other instruments to secure the transaction, thereby incurring additional costs. Also, registration duties for securities (eg for non-possessory pledges) under the laws of the state of destination will impose additional burdens on lenders.

Does such a policy of (complete or partial) non-recognition of foreign securities qualify as "measure of equivalent effect" prohibited by EC art 28?

Viewed in the perspective of ECJ case-law concerning the free movement of goods ("Keck"[52]) it has been argued that the granting of credit to the buyer secured by a reservation of title could be regarded as a form of *promoting* the sale of goods.[53] As a "promotion measure" it would be classified as a "selling modality" which, on the basis of "Keck", is prohibited by EC art 28 only if the provisions of national property law were discriminatory in law or in fact. Irrespective of this distinction between "product rules" and "selling modalities" as set forth in "Keck"[54] there are other national provisions that might be governed by EC art 28 such as authorisation or registration requirements, total bans on imports or sale, and obligations to provide data for statistics. All these provisions have been regarded as measures of equivalent effect though they do not (easily) fall under one of the two categories.[55] Also, provisions that are exclusively directed to imported goods or that are applicable as a consequence of crossing national borders would qualify as measures of equivalent effect.[56] Accordingly, in my opinion the rule (policy) of non-recognition qualifies neither as "product and designation rules" (covered by the *Dassonville* approach[57]) nor as so-called

52 ECJ 24 November 1993, C-267 and 268/91, Keck and Mithouard, ECR 1993, I-6097.

53 Eva-Maria Kieninger, 'Securities in Movable Property within the Common Market' (1996) 4 Eur. Rev. Priv. Law 41, 60; Eva-Maria Kieninger (n 1) 152; Frank Diedrich, 'Warenverkehrsfreiheit, Rechtspraxis und Rechtsvereinheitlichung bei internationalen Mobiliarsicherungsrechten' (2005) 104 ZVglRWiss. 116, 122.

54 ECJ 24 November 1993 (n 52) para 15–16.

55 See for the case law of the ECJ: Wyatt /Dashwood (n 37) 601.

56 Cf. the overview of the case law in: Wyatt/Dashwood (n 37) 611.

57 ECJ 11 July 1974, Case 8/74, Dassonville, ECR 1974, 837 para 5; see Stephen Weatherill/Paul Beaumont, *EU Law*, 3rd ed 1999, 503.

"selling modalities". Instead, the policy of non-recognition should be seen as a *distinct category* of measures of potentially equivalent effect in its own right.[58]

The following two arguments may support this assumption: First, the described policy of non-recognition of securities is closely connected with the *cross-border movement* of an asset: At the very moment an asset is moved to another state the attached security right may extinguish. Pursuant to the ECJ legal effects connected with the crossing of a state border are deemed as a measure of equivalent effect even if the same effect would have been achieved in wholly intrastate transactions as well.[59] In this case interstate and intrastate movements of goods are treated differently to the disadvantage of imported goods. Secondly, the policy of non-recognition of securities works as a remote barrier of market access: The seller will either abstain from exporting the goods to that state, or have to shop for a security right that survives any border crossing. It seems save to say that this effect amounts to a "measure of equivalent effect" which calls for a justification.

b) Free movement of capital

An infringement of the freedom of capital movement[60] may also occur if, in cases of retention of title of sold goods the goods are moved across the border: The retention of title can be seen as a security right established in favour of a seller who grants a loan to a (perhaps out-of-state) buyer.[61] EC art 56 sec 1 requires an *interstate dimension* of the transaction which is given if, eg, a loan agreement is concluded between parties residing in different Member States, or if a security right attached to an asset is moved from one to another Member State. Freedom of capital movement protects not only transborder investments but also the free movement of capital, i.e. security rights attached to assets, in the internal market.[62]

58 Though the ECJ classifies advertising regulations as "selling modalities" the more preferable view seems to be to treat them as a separate category of measures; Wyatt/Dashwood (n 37) 599. Another category of regulations – use restrictions – is now before the ECJ; see opinion of AG Kokott, 14 December 2005, C-142/05, Aklagaren; opinion of AG Léger, 5 October 2006, C-110/05, Commission ./. Italy.

59 Peter-Christian Müller-Graff, 'Art 28 EG No. 71–83', in: Hans von der Groeben/Jürgen Schwarze, *Kommentar zum Vertrag über die Europäische Union und zur Gründung der Europäischen Gemeinschaft*, 6th ed 2003, vol. 1.

60 A discussion of the relationship between the free movement of goods provisions and the freedom of capital movement is beyond the scope of this paper.

61 See AG Cosmas, C-222/97, Trummer und Mayer, ECR 1999, I-1663 para 9.

62 Jürgen Bröhmer, 'Art 56 EGV para 13, 54', in: Christian Callies/Matthias Ruffert, *EUV/EGV*, 3rd ed 2007 (concerning the import, export, and transit of capital).

A *restriction* of capital movement obtains whenever the transborder movement of capital is burdened in a specific manner, eg if an existing security right attached to a movable is "disinvested" and thereby denied access to the territory of another Member State. This in turn is the case when the state of destination deems a foreign security right as non-existent either because it is simply unknown to its legal order, or because it does not comply with it's registration or form requirements.

In such case not the *lex rei sitae* as such seems problematic with regard to the free movement of capital but its *combination* with the applicable substantive property law provisions. Moreover, the *lex rei sitae* combined with a full-scale *recognition* of security rights created on the basis of another legal system,[63] would not restrict the freedom of capital movement at all. In case the law of the new *situs* will not recognize a validly created security right, or will treat it differently from the law of its origin, the resulting restriction of the free movement of capital requires a justification to be upheld. Such justification may be found in the so-called "mandatory requirements" of the public interest of the importing state.

V. Justifications

1. Mandatory requirements

In general, national provisions infringing the freedom of capital movement and/or the free movement of goods may be justified, if applied in a non-discriminatory manner, by the so-called "mandatory requirements" relating to the "public interest" ("general good").[64]

63 As for recognition of a right created under a foreign law as an alternative to classical conflict-of-law rules see Heinz-Peter Mansel (n 31) 651; Wulf-Henning Roth (n 31) 338, 342; cf. also eg Dieter Henrich, 'Anerkennung statt IPR: Eine Grundsatzfrage' (2005) IPRax 422; Paul Lagarde, 'Développements futures du droit international privé dans une Europe en voie d'unification: quelques conjectures' (2004) 68 RabelsZ 225; Marc Fallon/Johan Meeusen, 'Private international law in the European Union and the exception of mutual recognition' (2002) 4 Yearbook Priv. Int. Law 37.

64 From the case law of the ECJ relating to free movement of capital: ECJ 4 June 2002, C-509/99, Commission v. Belgium, ECR 2002, I-4809 para 45; ECJ 4 June 2002, C-483/99, Commission v. France, ECR 2002, I-4781 para 45; ECJ 28 September 2006, C-282/04, C-283/04, Commission v. Netherlands, para 38; ECJ 14 September 2006, C-386/04, Walter Stauffer, para 42; Jürgen Bröhmer, in: Callies/Ruffert (n 58), art 56 EGV para 56. Free movement of goods: ever since ECJ 20 February 1979, case 120/78, Rewe-Zentral ("Cassis de Dijon"), ECR 1979, 649 para 9. See also the four-prong test set forth in ECJ 30 November 1995, C-55/94, Gebhard, ECR 1995, I-4165 para 37 (with regard to freedom of establishment).

a) In general

So far, the ECJ has accepted a number of mandatory requirements of public interest. In *Cassis de Dijon*, which mentions the mandatory requirements for the first time, the ECJ referred to protection of public health, fairness of commercial transactions, consumer protection, and the effectiveness of fiscal supervision as examples for a public interest justification.[65] These "mandatory" (imperative) requirements relating to the public interest are considered as judge-created justifications (besides the express derogations in the Treaty, like EC art 30).[66] There is no closed list for the mandatory requirements, and the ECJ, in the development of its case law, has added a number of other justifications to such list such as the protection of environment, protection of culture, plurality of the media, financial stability of the social security system etc.[67]

b) Security rights

Substantive law provisions concerning security rights reflect basic policies that may qualify as mandatory requirements of the public interest. The object of the protection of transparency and confidence of the market partners is at the heart of those provisions of substantive law that provide for a *numerus clausus* of security rights and that give a mandatory character to those provisions that shape the content of security rights. Registration requirements pursue the same *telos*.

Moreover, any legal system has to provide certain priority rules to determine the ranking of securities granted to multiple creditors; it has to establish a certain order among property and security rights, and among various creditors. With regard to the enforcement of securities priority rules can be deemed as fundamental task for a legal system. Further, priority rules are closely linked to the economic order of each Member State and should therefore be regarded as a "public interest" for the purpose of applying the fundamental freedoms.[68]

European law does neither provide for priority among creditors (eg in case of insolvency) nor does it determine whether or not it regards publicity of

65 ECJ 20 February 1979, C-120/78, Rewe-Zentral ("Cassis de Dijon"), ECR 1979, 649 para 8.

66 As for the (more theoretical) question whether the "mandatory requirements" case law concern so-called "immanent limitations" of the prohibition of EC art 28 or justifications see Michael Fremuth, "*Cassis de Dijon* – Zu der dogmatischen Einordnung zwingender Erfordernisse", Europarecht 2006, 866.

67 With regard to freedom of establishment and freedom to provide services see Wulf-Henning Roth, in: Dauses (ed) (n 36) E.I. para 99–108, 199–209.

68 Eva-Maria Kieninger (n 53) 63–64; Thilo Rott (n 2) 63; Sylvia Kaufhold (n 2) 298; see also Peter von Wilmowsky (n 2) 122, 195.

security rights as an important policy. Consequently, it is still within the discretion of each Member State to take the basic policy decisions in this regard[69] as long as it will not infringe the freedoms of the EC.

The *Krantz* judgment may illustrate this point. The judgment deals with the competence of the Netherlands Collector of Direct Taxes to seize (all) movable property located at the premises of the tax debtor, including the seizure of movables purchased from an out-of-state company on installment terms, with reservation of title for the seller. According to Dutch law the reservation of title can be ignored for the purpose of collecting taxes from the purchaser. With regard to EC art 28 (ex ECT art 30) the ECJ held that these negative consequences for the out-of-state seller should be regarded as "too uncertain and indirect to warrant the conclusion that a national provision authorizing such seizure is liable to hinder trade between the Member States".[70] The judgment deserves three observations. First, by classifying the burden as "too indirect", the ECJ successfully evades the task to deal with the issue of justification by the "mandatory requirements". One may assume that this route was deliberately taken to leave the Member States' competence to regulate the enforcement of security rights untouched. Secondly, the ECJ stresses that EC art 28 were applicable in case that the national provision had discriminated against imported goods, or sought to control trade with other Member States.[71] This statement may be taken as an indication for the more general proposition that as far as the ranking of creditors inside and outside insolvency proceedings is concerned, the Member States have to prevent any discriminatory effects vis-à-vis imported goods. Thirdly, the judgment does not refer to freedom of capital movement (which was not directly applicable at the time of the judgment); therefore, there is no discussion of the issue whether the Dutch tax provisions might be regarded as a restriction of capital movement that needs to be justified.

It may therefore be safely assumed that Member States are competent to legislate on the order of proprietary rights and the priority of creditors in a non-discriminating fashion, and that, in any event, such legislation might be justified by the mandatory requirements jurisprudence.[72] Moreover, Member States are competent to determine the geographic scope of the national provisions to be applied. In this regard the *lex rei sitae* may appear as appropriate mean to secure

69 Eg whether the relationship between creditors, as proposed by Peter von Wilmowsky (n 2), 122, should be left to the "market", ie the competition between creditors, with state regulation restricted to establishing the "rules of the game" such as the priority principle, or whether a State may go beyond in its intervention shaping a mandatory system of creditor rights and the relationship between them.

70 ECJ 7 March 1990, C-69/88, Krantz, ECR 1990, I-583 para 11.

71 ECJ 7 March 1990 (last n) para 10.

72 Peter Wohlgemuth (n 2) 134 seems to be sceptical on this point.

and enforce the policies of national substantive law, as long as these policies are pursued in a systematic fashion.[73]

In the following, we will discuss the restrictions on the free movement of capital and goods in the light of "mandatory requirements". The discussion will focus on the most apparent restrictions such as the policy of non-recognition of a security right unknown to the legal order of the importing State, form and registration requirements, and regulations concerning the ranking of creditors.

2. The standards

In order to be justified by public interests, a national measure has to fulfil at least two conditions: the measure must be *suitable* for securing the attainment of the objective (in the public interest) which it pursues, and the measure in its effect must not go beyond what is *necessary* to attain the objective (principle of necessity). Moreover, in some judgments the ECJ has alluded to the standard of *proportionality* (in the narrow sense);[74] and in some other cases the ECJ has (unsystematically) focused on the question whether the Member pursues the public interest in a *systematic* fashion.[75]

Provisions in national property law which require the registration of security rights may be regarded as *suitable* to pursue a policy of publicity and transparency with regard to third parties interests, such as the interest to be informed whether a certain asset has been charged and who has title to the asset. Whether such provisions comply with standards of *necessity* and *proportionality is a different question*.

3. The issues

a) The numerus clausus principle

As pointed out above (see IV.1.), the *numerus clausus* principle established in national property law for the *creation* of security rights does not violate the freedoms.[76] Property law and, as part of it, the *numerus clausus* principle belong to the infrastructure of a legal system, which in turn is generally protected by the principles set forth under EC art 295.

73 The *lex rei sitae* corresponds to the applicable insolvency law (*lex fori*) insofar as the proceedings concern assets located within the state of the proceedings.

74 ECJ 25 October 2001, C-49, 50, 52–54, 68–71/98, Finalarte, ECR 2001, I-7831 para 50; ECJ 6 November 2003, C-243/01, Gambelli, ECR 2003, I-13031 para 72.

75 ECJ 5 June 2007, C-170/04, Rosengren, para 51-54; but see ECJ 13 July 2004, C-262/02, Commission ./. France, ECR 2004, I-6569 para 33; ECJ 13 July 2004, C-429/02, Bacardi France, ECR 2004, I-6613 para 40, in which the Court outspokenly did not give weight to this principle.

76 In accord eg Christiane Wendehorst (n 11) vor Art 43 EGBGB No. 6.

EC art 295 does, however, not dispense the Member States from their obligation to legislate in conformity with the fundamental freedoms:[77] As discussed above (IV.2.) the *numerus clausus* principle may become problematic if, following a *Statutenwechsel*, it is applied by Member State B to a security interest that has been validly created under the law of Member State A. The denial of the law of Member State B to recognize such a validly created security interest may qualify as a restriction of the free movement of capital (and/or the free movement of goods). For justification purposes it must be asked whether the underlying policies of the *numerus clausus* principle might also be enforced by a less severe restriction of the freedoms concerned.

The *numerus clausus* principle pursues policies of simplicity and transparency which mainly protect the general public, especially creditors, with regard to security rights unknown to them. These policies, however reasonable and sensible they seem when applied to a national setting (especially in case of the creation of securities), require a different assessment in international settings:[78] Interstate trade with its potential involvement of various legal orders necessarily leads to an increase in the complexity of legal relationships; eg with regard to an imported asset creditors will have to check the proprietary status of the asset on the basis of foreign law as the law of the former *lex rei sitae*. Given that the *numerus clausus* principle as applied to security rights may appear as too restrictive with regard to the free movement of capital.[79]

There are two alternatives to the *numerus clausus* principle which might be *less restrictive*: One approach which is taken by German private international law attempts to "transpose" a security right created under foreign law into an equi-

77 ECJ 6 November 1984, Case 182/83, Fearon, ECR 1984, 3677 para 7; ECJ 1 June 1999, C-302/97, Konle, ECR 1999, I-3099 para 38; ECJ 4 June 2002, C-483/99, Commission ./. France, ECR 2002, I-4781 para 44; Torsten Koerber (n 21) 532; Helge Großerichter, 'Vom Umgang mit ausländischen Zivilrechtslagen im Bereich EG-vertraglicher Grundfreiheiten: Eine Zwischenbilanz der Diskussion um Niederlassungsfreiheit und Sitzanknüpfung', in: *Festschrift für Hans Jürgen Sonnenberger*, 2004, 369, at 385; Jürgen Basedow (n 31) 44; Jacobien W. Rutgers (n 2) 175; contra: Hans Jürgen Sonnenberger (n 28) No. 160; Thilo Rott (n 2) 61. For an in-depth analysis of art 295 EC see Daniela Caruso, 'Private law and public stakes in European integration: The case of property' (2004) Eur.L.J. 751, 757.

78 Cf. Hans Stoll, 'Zur gesetzlichen Regelung des internationalen Sachenrechts in Artt. 43–46 EGBGB' (2000) IPRax 259, 262.

79 A legal order in which the numerus clausus principle is not followed in a straightforward manner will have difficulties to justify impediments for the freedoms for lack of a coherent and systematic enforcement of the public interest pursued; see n 64. Eg German courts may be regarded to have ignored the numerus clausus principle by developing the notion of *Sicherungsübereignung* (fiduciary pledge).

valent security right under German law.[80] This approach considers not only the policies of transparency and simplicity but protects also third party interests to limit any burdens and difficulties resulting from the need to collect information on an unknown legal system under which the security right has been created. Consequently, the application of the *numerus clausus* principle might be justified if the law of the new *situs* provides also for a transposition of foreign security rights into functional equivalent security rights.

However, it should be admitted that the instrument of transposition may not always completely fulfil what the freedoms require: The doctrine of transposition will only work if the legal order of the new *situs* offers a functionally equivalent security right; that is not the case if the gap between the two legal orders involved becomes too wide.[81] Another route that would escape these deficiencies of the transposition approach[82] would be to basically *recognize* a security right that has been validly created under foreign law as a *foreign* security right. The wording of art 43 sec 2 German EGBGB seems to prescribe that route.[83] In order to inform the public with regard to the existence of such foreign security right and the applicable foreign law, its recognition might even be combined with an obligation to register the security right as a right created under a foreign legal system within a certain grace period. In case the exercise of foreign security rights conflicts with basic principles of the law of the new *situs* the *exercise* of such rights might be limited.[84]

Finally, a *numerus clausus* principle that is combined with a policy of non-recognition of foreign security rights appears to be overly restrictive with regard to the relevant freedoms.

b) Refusal to recognize non-possessory rights

A legal order which does not provide for the creation of non-possessory security rights with effect against third parties[85] pursues the policy of *publicity* of proprietary rights as the basis of its domestic credit and security system. Such system protects the reliance of third persons (creditors) that the possession of an

80 See for this approach Christiane Wendehorst (n 11) Art 43 EGBGB No. 149–151; Peter von Wilmowsky (n 2) 108; Thilo Rott (n 2) 9; Sylvia Kaufhold (n 2) 266; Eva-Maria Kieninger (n 53) 41, 48.

81 Peter von Wilmowsky (n 2) 119; Eva-Maria Kieninger (n 53) 41, 49; Thilo Rott (n 2) 12; Anne Röthel, 'Internationales Sachenrecht im Binnenmarkt' (2003) JZ, 1027, 1031.

82 Another deficiency of the transposition approach arises in case that the national security right into which the foreign right has been transposed gives the proprietor more rights than the foreign security right.

83 Hans Stoll (n 79) 262; Christiane Wendehorst (n 11) Art 43 EGBGB No. 152–153; Bernd von Hoffmann/Karsten Thorn, *Internationales Privatrecht*, 8th ed 2005, § 12 No. 31; Anne Röthel (n 82) 1031.

84 Cf. art 43 sec. 2 EGBGB.

85 See Peter Wohlgemuth (n 2) 58, and Barbara Graham-Siegenthaler (n 2).

asset indicates that no non-possessory securities are attached thereto. It has been doubted whether this rule of non-recognition can be regarded as a suitable means for the protection of the reliance of creditors at all.[86] To what extent should such reliance be protected? The mere fact of possession of an asset does not purport any reliable information regarding title. It only tells the (potential) creditor that, in case that the possessor is the owner, no non-possessory rights are attached. Protection of third party interests should rather relate to title than to the non-existence of security rights.

Given the harsh consequences (above II.) that arise from the refusal to recognize non-possessory security rights the restriction on the interstate movement of goods and capital will need a justification that is pursued in a systematic and consequent manner.[87]

According to Austrian law a fiduciary pledge is only validly created if the pledgor obtains possession of the chattel. This principle is also applied with regard to a fiduciary pledge created under foreign law in case the chattel is moved to Austria. A transposition of the foreign security right into Austria will not succeed.[88] However, one may doubt whether Austrian law follows its policies of creditor protection in a coherent fashion as it accepts the reservation of title as a security right without requiring that the creditor/owner of the chattel retains possession.[89]

Apart from the aspect of coherent enforcement of justified policies one will have to ask whether there are less restrictive means than a complete refusal to recognise the foreign security right available. National rules requiring a non-possessory security right to be registered would serve the informational function in an equivalent manner but would appear less infringing with regard to the interstate movement of goods and capital compared to a total refusal of a foreign security right.

c) Registration requirements

Provided a registration requirement for a non-possessory security right created under a foreign law is regarded less restrictive than its complete non-recognition, the principle of proportionality would require the law of the new *situs*

86 To this point Peter von Wilmowsky (n 2) 169; but see Thilo Rott (n 2) 51.

87 See for this criterion eg Eva-Maria Kieninger (n 1) 180.

88 Judith Schacherreiter, 'Publizitätsloses Sicherungseigentum im deutsch-österreichischen Grenzverkehr' (2005) ZfRV, 173, 174, 177. Courts have based the refusal to recognize the foreign non-possessory rights also on the *ordre public* or on the notion of the internationally mandatory character of the Austrian provisions concerning possessory security rights.

89 Cf. Judith Schacherreiter (n 89) 183.

to enable the security holder upon an asset has been moved to the new destination to uphold his/her security right under the law of the new *situs* within a reasonable time-period, eg by providing for an appropriate grace period for registration (and, perhaps, for ranking purposes).[90]

d) Formal requirements

In some Member States a security right (eg retention of title) will be regarded as validly created only if certain formal requirements (eg written contract; *data certa*) are fulfilled.[91] In case such formalities are required for the recognition of a valid foreign security right,[92] they will in fact bar the recognition of a foreign security right. For the purpose of justification the *telos* of such formal requirements has to be closely inspected:[93] If their purpose is to guarantee publicity vis-à-vis third persons one may doubt whether such provisions may be considered as appropriate to fulfil such intention. If they also intend to prevent some kind of fraud vis-à-vis third parties,[94] they might be justified as a less restrictive alternative as they can be interpreted as a rule of burden-of-proof in such case.

e) Transposition or recognition?

Further, it must be answered whether a restriction of the freedoms might be justified by the mere transposition of foreign securities (see above 3.a.) or whether they require a full recognition of the validly created foreign security right.

The fundamental freedoms generally leave it to the Member States to solve a conflict between their respective legal order and the freedoms as long as it eliminates the effected restriction.. Accordingly, the *transposition* approach should be regarded as being in conformity with EC law if and to the extent that the law of the new *situs* does not reduce the scope and content of a foreign security right. If it does not provide for functional equivalent security rights, the freedoms would require the Member State of the new *situs* to *recognize* the foreign security right as a right created under foreign law, in each case subject to certain limitations that may be justified by mandatory requirements.

90 Art 102 sec. 2 Swiss Code on Private International Law could serve as a model; see Barbara Graham-Siegenthaler (n 2) 72; Anne Röthel (n 82) at 1032.

91 Cf. Eva-Maria-Kieninger (n 1) 188; Barbara Graham-Siegenthaler (n 2) 225.

92 This seems to have been the approach of Italien courts in the past; cf. Christian von Bar/Ulrich Drobnig (eds) (n 5) 345 No. 525 (e). Whether art. 55 of the statute of 31 May 1995 has changed the law in this respect seems to be unclear; cf. Barbara Graham-Siegenthaler (n 2) 244.

93 Jürgen Basedow (n 31) 46.

94 See Barbara Graham-Siegenthaler (n 2) 225 (with regard to Italian law).

In this connection it should be recalled that in other fields of (public) law the ECJ has interpreted the fundamental freedoms as creating an obligation for the Member States to take the existence of legal provisions of other Member States into account.[95] This approach has also been applied to the law of corporations as EC artt 43, 48 establish a duty to recognize an entity's name validly created and used in the Member State of its (statutory) seat in any other Member State where such company has its business operations.[96] The ECJ has further held in its well-known *Überseering* judgment that Member States must recognize a corporation that has been validly incorporated according to the law of another Member States.[97]

It is to be admitted that under European law the legal status of a corporation is a matter different from the status of a security right that has been validly created under the law of a certain Member State; EC art 48 transfers the right of establishment and the freedom to provide services everywhere in the internal market to corporations, thus giving them the same legal status under European law as natural persons. However, what seems to be important is another aspect of this case-law: Member States must take into account that interstate settings inherently involve difficulties for out-of-state traders that are not present in a completely intrastate setting. This obligation which extends to the status of Union citizens as well[98] has to be respected by the Member States with regard to the application of all freedoms and in all fields of law – including the field of property law.[99] Insofar it may be argued that Community law as it stands today demands the Member States to respect and recognize a legal status or right that has been validly created under the law of another Member State.[100] With regard to national mandatory requirements in each Member State it should be noted that the mere complexity of recognising foreign security rights may not suffice to justify a refusal of their recognition.[101] It is, however, another matter whether and to what extent the Member States may still follow their policies with regard to the ranking of creditors and security rights.

95 ECJ 17 December 1981, Case 272/80, Frans Nederlandse Maatschappij, ECR 1981, 3277 para 14–16; ECJ 26 January 2006, C-514/03, Commission ./. Spain, ECR 2006, I-963 para 27; see for further references: Wulf-Henning Roth, in: Dauses (ed) (n 38) No. 106, 205; Thorsten Kingreen, in: Christian Callies/Matthias Ruffert (eds) (n 63) art 28–30 EGV No. 96.

96 ECJ 11 May 1999, C-255/97, Pfeiffer Großhandel, ECR 1999, I-2835 para 20.

97 ECJ 5 November 2002, C-208/00, Überseering, Slg. 2002, I-9919 para 59, 82.

98 ECJ 2 October 2003, C-148/02, Avello, ECR 2003, I-11613 para 37; case comment by Thomas Ackermann (2007) 44 C.M.L.Rev. 141.

99 Wulf-Henning Roth (n 17) 23; Helge Großerichter (n 77) 384; Heinz-Peter Mansel (n 31) 731; see also Anne Röthel (n 82) 1031.

100 See the scholarly literature cited in n 63.

101 AG Tizzano, 7 July 2005, C-411/03, SEVIC Systems, ECR 2005, I-10808, para 62–65.

f) Rules of priority and ranking of creditors

Most important for the enforcement of security rights are provisions that deal with the relationship between multiple creditors and with the priority among multiple property rights. Registration requirements for security rights may relate to this issue.[102] It has been argued that it is within the competence of the state of the *situs* of the asset (or the state where the debtor is domiciled) to determine the ranking of property rights and creditors.[103] This is what in effect the ECJ decided in *Krantz*:[104] Dutch law was held to be competent to give the Netherlands Collector of Direct Taxes as creditor priority status vis-à-vis a creditor who had secured his claim by a reservation of title (which indeed was ignored for the purpose of collecting taxes). In its judgment the ECJ stressed that imported goods may not be discriminated at the stage of enforcement. The same rule may apply to security rights attached to imported goods which may not be discriminated either.

In the *Krantz* proceedings the tax collector had seized movable property found on the premises of the tax debtor irrespective of the origin of the goods. Dutch property law attributes the same consequences to a reservation of title clause as German law does: The seller of goods remains the owner until the purchase price has been fully paid.[105] The Dutch court assumed that the reservation of title created under German law could be assimilated to Dutch law. The enforcement of tax claims despite a reservation of title in effect gave priority to tax authorities vis-à-vis creditors. It did not lead to a refusal to recognize a security right set up under foreign law. By classifying the Dutch enforcement provisions as "too indirect" to amount to a prohibited restriction of the free movement of goods the judgment may stand for the proposition that the ranking of creditors and securities is a matter for the Member State which has jurisdiction to pursue enforcement or insolvency proceedings.

With regard to the treatment of foreign security rights the reference to the principle of non-discrimination in the *Krantz* judgment should be viewed in a somewhat broader context. A Member State that (like the Netherlands in the respective case) provides for a transposition of foreign rights will not face any problems insofar as the foreign security rights will in fact be transposed into functional equivalent domestic rights. This approach *grosso modo* ensures a non-

102 Peter von Wilmowsky (n 2) 160.

103 Peter von Wilmowsky (n 2) 171.

104 See the text above at n 68. Actually the judgement can be explained on the basis of the *lex rei sitae*, the applicability of the *lex debitoris* or the applicability of Dutch taxation law as public law of the Netherlands.

105 See Jacobien W Rutgers (n 2) 13; Eva-Maria Kieninger (n 1) 56; Wolfgang Mincke, *Einführung in das niederländische Recht*, 2002, No. 158–159.

discriminatory treatment in the enforcement (insolvency) procedure. In case a Member State follows or has to follow the recognition approach (see above e.) it must treat foreign security rights (perhaps unknown to the domestic legal order) in a non-discriminatory way. It should be remembered that the principle of non-discrimination not only requires that comparable situations should be treated equally but also that non-comparable situations have to be treated differently.[106] Accordingly, the non-discrimination principle obliges each Member States to enforce foreign security rights equally to any of its own functionally equivalent security rights. As far as no such functionally equivalent security rights of the *lex fori* exist the non-discrimination principle will require an in-depth analysis and classification of the foreign security right against the background of the legal order under which it has been created, its position and relationship to other (competing) security rights, and its position in the enforcement and insolvency proceedings of that legal order; in such case the foreign security right must be seen and interpreted in its relation to domestic security rights thereby avoiding any disadvantageous treatment.

VI. The mandate for legislation

Does the European Community have a mandate to approximate rules concerning security rights and/or to create a European security right on its own?

1. EC artt 61 lit. c), 65 lit. b)

EC artt 61 lit. c), 65 lit. b) provide the legal basis for the European Community to legislate with regard to private international law. The scope of these provisions extends to issues that go beyond the free movement of persons (as referred to in the heading of Title IV of the Treaty).[107] As questions of "recognition" of foreign security rights are essentially questions relating to the application of foreign law which may be dealt with by conflict-of-laws rules the European Community is competent to legislate with regard to issues of recognition as discussed in this paper. In contrast, the harmonisation of substantive private law cannot be based on EC artt 61 lit. c), 65 lit. b).[108] In this regard, we must look whether the EC Treaty provides for another competence rule.

106 ECJ 2 October 2003, C-148/02, Avello, ECR 2003, I-11613 para 31.

107 Matthias Rossi, in: Christian Callies/Matthias Ruffert (eds) (n 63) Art 65 EGV No. 7; *contra*: Markus Ludwigs, 'Harmonisierung des Schuldvertragsrechts in Europa' (2006) Europarecht 370, 381.

108 Stefan Leible, in: Rudolf Streinz (ed), *EUV/EGV*, 2003, Art 65 EGV No. 20.

2. EC art 95

As far as restrictions of free movement of capital are concerned, the legislative competence of the European Community could formerly be found in ECT artt 69 and 70. The Treaty of Amsterdam (1997) has eliminated these provisions and referred the European legislator to the general provisions of the Treaty.[109] Accordingly, legislative measures approximating national provisions with relation to capital movement have to be based either on EC artt 94, 95, or, maybe, on EC art 308. The same provisions may serve as a basis for strengthening the internal market with regard to the free movement of goods.

EC art 96 authorizes the European Community to act if diversities between legal provisions of the Member States lead to a (grave) distortion of competition. Until today, the scope and the preconditions for the application of this provision have remained uncertain. As EC art 96 has never been used as a basis for legislation so far,[110] and seems to have fallen in oblivion, we will consider only EC art 95 for our purposes. This provision empowers the European legislator to undertake measures for the approximation of national rules provided that they are directed to establish or to support the functioning of the internal market. As the ECJ has pointed out in its *Tabacco I* judgement EC art 95[111] may not be interpreted in such a way as to confer on the Community a *general* power to regulate the internal market.[112] Consequently, the mere diversity of national provisions as such will not suffice as basis for Community action.[113] The European Community's power to legislate is limited to cases where the diversity of national

109 Jürgen Bröhmer, in: Christian Callies/Matthias Ruffert (eds) (n 62) Art 56 EGV para 2.

110 Wolfgang Kahl, in: Christian Callies/Matthias Ruffert (eds) (n 62) Art 95 EGV No. 9.

111 And art 47 sec. 2 EC alike; see ECJ 5 October 2000, C-376/98, Germany ./. European Parliament, ECR 2000, I-8419 para 107.

112 ECJ 5 October 2000 (n 111) para 83.

113 ECJ 5 October 2000 (n 111) para 84; ECJ 12 December 2006, C-380/03, Germany ./. European Parliament, para 37. Insofar the legal basis of Council Directive of 20 December 1985 to protect the consumer in respect of contracts negotiated away from business premises (85/577/EEC), O.J. 1985 L 372/31, is more than doubtful: In recital No. 2 of the preamble we find just a reference to the diversity between the national rules on consumer protection concerning contracts concluded in a doorstep-selling situation without any explanation how this diversity might lead to an obstacle to the free movement of goods or services; see Wulf-Henning Roth, 'Europäischer Verbraucherschutz und BGB' (2001) JZ 475, at 477; Stephen Weatherill, 'European Private Law and the Constitutional Dimension', in: Fabrizio Cafaggi (ed), *The Institutional Framework of European Private Law*, 2006, 79, at 88.

provisions either leads to an *appreciable* distortion of competition,[114] or[115] creates or is likely to create a restriction to the free movement of goods or capital.[116] With regard to security rights only the latter aspect might be seen as basis for legislative actions of the European Community approximating national provisions.

The *Tabacco I* judgment lead to a discussion whether non-discriminatory "selling modalities" that, according to *Keck*, are not subject to the prohibition of EC art 28 may nevertheless be approximated based on EC art 95: Is an impediment for market access as decisive requirement in EC art 28 equivalent to a (likely) "obstacle" to the free movement of goods which may constitute legislative power of the European Community according to EC art 95?[117] In the following we will not explore the issue in detail but stress three points: (1) Until today it is unclear whether and to what extent the *Keck* approach may be applied to freedoms other than the ones in EC art 28, especially the freedom of capital movement.[118] Moreover, it has to be accepted that a national provision which may be characterized as a selling modality for the purpose of EC art 28 may be treated as a "restriction" of another freedom like EC art 56 sec 1 requiring a justification. (2) Diversities between national rules concerning selling modalities may not impede the access to a specific national market; however, such provisions (eg rules on advertising; rules on unfair competition) may inhibit a uniform Community-wide merchandising activity, and thus amount to a considerable restriction to the

114 ECJ 5 October 2000 (n 111) para 95, 106. The ECJ argues that "to interpret (ex) Articles 100a, 57 (2) and 66 of the Treaty as meaning that the Community legislature may rely on those articles with a view to eliminating the smallest distortions of competition would be incompatible with the principle … that the powers of the Community are those specifically conferred on it." (para. 107).

115 The two basis for legislation in Article 95 sec. 1 EC have to be applied alternatively, not in a cumulative fashion; ECJ 12 December 2006 (n 113) para 67.

116 ECJ 5 October 2000 (n 109) para 84 (the mere finding of disparities and of an abstract risk of obstacles was held not enough to justify the use of ex art 100a EC); ECJ 12 December 2006 (n 111) para 37–38.

117 *Pro*: Markus Ludwigs, *Rechtsangleichung nach Art 94, 95 EG-Vertrag*, 2004, 196 (with further references in n 942), 363; Karel Mortelmans, 'The relationship between the Treaty rules and Community measures for the establishment and functioning of the Internal Market – Towards a concordance rule' (2002) 39 C.M.L.Rev. 1303, 1326; Martin Selmayr/Hans-Georg Kamann/Sabine Ahlers, 'Die Binnenmarktkompetenz der Europäischen Gemeinschaft' (2003) EWS 49, 52; *contra*: Gareth Davies, 'Can selling arrangements be harmonised?' (2005) 30 Eur.L.Rev. 370, 373.

118 The literature on this topic is abundant; see eg Sonja Feiden, *Die Bedeutung der "Keck"-Rechtsprechung im System der Grundfreiheiten*, 2003, and the articles by Jukka Snell/Mads Andenas, Hans D Jarass, José Luís da Cruz Vilaca, and Wulf-Henning Roth, in: Mads Andenas/Wulf-Henning Roth (eds), *Services and Free Movement in EU Law*, 2002.

functioning of the internal market.[119] (3) The refusal to recognize foreign security rights should not be characterized as a mere "selling modality" but as a distinct category of restrictions under EC art 28 (and EC art 56) (see above IV.2.a.bb.), which requires individual justifications.

In the academic discussion it has been stressed that the key question for the future of the harmonisation of private law will be to determine the exact threshold of ("likely") "obstacles".[120] This question certainly must be analysed for each fundamental freedom separately, thereby considering new developments in the distribution of goods and services (eg internet distribution of financial products). As demonstrated above (IV.2.a. and b.) certain aspects of national property law concerning security rights (eg the *numerus clausus*-principle, certain formal requirements, refusal to recognize unknown foreign security rights) may cause a relevant impediment for the free movement of capital as well as for the free movement of goods. As we have shown, these restrictions can partly be removed by the direct application of the freedoms. Whereas to the extent restrictions must be justified by the mandatory requirements of the public interest their removal would require the approximation of national laws. Moreover, in order to enhance legal certainty for participants in interstate trade the European Community may develop a *régime* recognizing validly created security rights in all Member States, working with utmost effectiveness. Legal certainty could be further strengthened by a (minimum) harmonisation of the substantive law of security rights (including priority issues with regard to enforcement and insolvency proceedings) and the introduction of parties' autonomy as proposed by some authors.[121]

It should be noted that the harmonisation powers of the European Community do not only relate to interstate but also to intrastate situations.[122] Also, as far as these powers are based on EC art 95, they are not limited by EC art 295 which states that the Treaty shall not work to the detriment of the national system

119 For an argument that the diversity of contract laws in the EC though not an impediment to market access may nevertheless be regarded as an "obstacle" in the light of the *Tabacco I* judgment: Stefan Vogenauer/Stephen Weatherill, 'The European Community's Competence to Pursue the Harmonisation of Contract Law – an Empirical Contribution to the Debate', in: Stefan Vogenauer/Stephen Weatherill (eds), *The Harmonisation of European Contract Law*, 2006, 105, 136 (based on empirical research).

120 Stephen Weatherill, 'The Commission's options for developing EC consumer protection and contract law: Assessing the constitutional basis' (2002) Eur.Bus.L.Rev. 497, 505.

121 Especially Peter von Wilmowsky (n 2); Jürgen Basedow (n 31) 48; Hans Stoll (n 79) 264.

122 See ECJ 20 May 2003, C-465/00, Rechnungshof ./. Österreichischer Rundfunk, para 41; ECJ 6 November 2003, C-101/01, Bodil Lindqvist, para 40–41.

of property. As argued above (IV.3.a.), EC art 295 does not require the Member States to deviate from the freedoms but to adjust their national property law to the requirements of the freedoms.[123]

3. EC art 308

Whereas EC art 95 can be seen as proper legal basis for the harmonisation of the national rules on security rights, it may not serve as authorization to establish a new European legal instrument such as the "European security right", which has been forcefully proposed since a long time.[124] In a recent judgment concerning the European Cooperative Society regulation, the ECJ held that an act based on EC art 95 would require a diversity of national regulations which is to be eliminated by an instrument of the European Community. Whereas EC art 95 would not justify the introduction of new legal instruments such as a European society or a European security right with a specific Community character in addition to existing national laws;[125] instead, those European instruments can only be based on EC art 308[126] if its preconditions are met.[127]

The implementation of a European security right would serve the same purpose as the harmonisation of national private law provisions concerning security rights: To enhance the functioning of the internal market. In such case, any legal actions intending to harmonize the national laws would comply with EC art 308 which requires any instruments to realize objectives of the Treaty. Therefore, for the introduction of a European instrument such as the European security right EC art 308 seems to be the proper legal basis.

According to EC art 308 the implementation of a European instrument must be "necessary" with respect to its purpose to promote the functioning of the

123 ECJ 4 June 2002, C-367/98, Commission ./. Portugal, ECR 2002, I- 4731 para 48; ECJ 4 June 2002, C-483/99, Commission ./. France, ECR 2002, I-4781 para 44.

124 Karl Kreuzer, 'Europäisches Mobiliarsicherungsrecht oder: Von den Grenzen des Internationalen Privatrechts', in: *Festschrift für Overbeck*, 1990, 613, 637; see also Sylvia Kaufhold (n 2) 216; Peter Wohlgemuth (n 2) 270; Christel Bourbon-Seclet (n 2) 501, 507.

125 ECJ 2 May 2006, C-436/03, European Parliament ./. Council, para 39; see also ECJ 15 November 1994, opinion 1/94, ECR 1994, I-5267 para 59; Markus Ludwigs (n 115) 228, with further references; Stefanie Schreiber, 'Art 308 EGV No. 21', in: Jürgen Schwarze (ed), *EU-Kommentar*, 2000.

126 Cf. ECJ 9 October 2001, C-377/98, Netherlands ./. Parliament and Council, ECR 2001, I-7079 para 25.

127 ECJ 2 May 2006, C-217/04, United Kingdom ./. European Parliament, para 44: The creation of a Community instrument may be based on art 95 EC only in case that the instrument is meant to serve a mere supplementary function to a Community act for the harmonization of national provisions validly based on art 95 EC.

European market. Given the fact that a mere harmonisation of conflict-of-laws rules would not suffice to remove the existing restrictions, and that a harmonisation of the national provisions in the field of securities might strongly affect the private law of each Member State, the creation of an *optional* 28th security right instrument appears to be an attractive alternative. Such a "European security right" further defined in a European regulation, would apply only upon the parties' choice; it could therefore exist in addition to national legal *régimes* which remained mainly untouched.[128] Such an approach would also correspond with the notion of subsidiarity[129] which is explicitly referred to in EC art 308.

VII. Summary

1. Provisions of civil law and conflicts of law might be subject to the fundamental freedoms of the EC-Treaty.

2. With regard to the creation of security rights, both the *lex rei sitae* and the *numerus clausus*- principle in national property law are in conformity with the freedoms.

3. Any provisions and practices in national law refusing the recognition of security rights validly created under the law of another Member State may qualify as prohibited restriction under the free movement of goods and capital provisions of the EC-Treaty.

4. A Member State's interest to protect creditors as well as other national policies providing for priority and ranking of securities and creditors may constitute mandatory requirements in the public interest justifying a restriction of the freedoms of the EC-Treaty. Whereas the *numerus clausus* principle as well as formal requirements of national law established for the creation and recognition of securities may conflict with the principle of necessity and proportionality when applied to a validly created foreign security right.

5. A *transposition* (assimilation) of a foreign security right into a functional equivalent security right of the new *situs* law is in conformity with the fundamental freedoms if such transposition does not restrict the foreign security right in its content and legal effects.

128 To be sure, the introduction of a "European security right" would need a concomitant harmonization of national law insofar as the position of the European right within the respective national legal order, eg in execution and insolvency proceedings, would have to be defined.

129 See art 5 (2) EC; see Ivo Schwartz, 'Art 308 EG No. 30–39, Art 308 EGV No. 21', in: Hans von der Groeben/Jürgen Schwarze (eds), *Kommentar zum Vertrag über die Europäische Union und zur Gründung der Europäischen Gemeinschaft*, vol. 4, 6th. ed 2004.

6. Where a transposition is not possible or would conflict with the fundamental freedoms the national law of a Member State must entirely recognize a valid foreign security right in order to comply with the freedoms.

7. In enforcement and insolvency proceedings a validly created foreign security right must not be treated in a discriminatory manner. This principle implies an obligation of the Member States to classify a foreign security right with view to the legal order of its origin, and to adjust (and to compare) it to domestic security rights.

8. The European Community has legislative power to harmonise conflict-of-laws rules relating to security rights based on EC art 65 lit. b).

9. The substantive law of security rights may be harmonised on the basis of EC art 95.

10. The implementation of a European legal instrument creating a "European security right" can be based on EC art 308.

Secured Credit and the Internal Market: The Fundamental Freedoms and the EU's Mandate for Legislation:

Commentary

by

Jacobien W Rutgers*

Table of Contents

I. Introduction

This paper's title, "Secured credit and the internal market: the fundamental freedoms and the EU's mandate for legislation" suggests two separate topics, which are (i) the use of free movement to solve the problems which relate to security interests in cross-border trade and (ii) the competence either to harmonise the rules on security interests or to create a European Security Interest. These issues are intertwined, since the competence to harmonise security interests at a European level requires *inter alia* either an infringement of the free movements or a distortion of competition,[1] and the creation of a European Security

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1 *Cf* Case C-376/98 *Germany* v. *Parliament and Council* [2000] ECR I-8419; Case C-66/04 *United Kingdom* v. *Parliament and Council* [2005] ECR I-10553; Case C-380/03 *Germany* v. *Parliament and Council* [2006] ECR I-11573. C Barnard, *The Substantive Law of the EU, The Four Freedoms*, Oxford: OUP, second edition, 2007, 573; W-H Roth, Case C-168/00 Simone Leitner v. TUI Deutschland GmbH & Co.

Interest requires measures to attain the objectives of the common market (Article 308 EC). This paper will focus on the competence of the European Community to provide measures with respect to security interests.

The problems in cross-border trade relating to security instruments concern the risk of losing a security interest when a movable is moved from one country to another; this is due to the application of the *lex rei sitae* together with the *numerus clausus* of a given legal system.[2] As a consequence, security instruments, for example the pledge and the retention-of-title clause are not as frequently used in international trade as in the national context. In international trade, parties usually resort to more expensive devices such as export insurance and bank guarantees.

In the literature, different solutions are offered to solve the problems concerning security interests in international transactions. Generally speaking, four types of solutions can be distinguished: firstly, the creation of a European security instrument that exists alongside national security instruments,[3] secondly, harmonization of substantive law, thirdly, harmonization of conflict rules and finally the influence of the free movements on possible solutions to the problems related to security instruments[4].[5] The article will focus on the question whether

KG Judgment of 12 March 2002 (Sixth Chamber), ECR 2002, I-2631, Common Market Law Review 40(2003) 937–951, at 943 et seq; J Snell, 'Free Movement and Competences in EC Law' (2003) 22 *Yearbook of European law*, P Eeckhout, T Tridimas (eds), Oxford: OUP, 322–351, 349.

2 See, *inter alia*, C von Bar, U Drobnig, *The Interaction of Contract Law and Tort and Property Law in Europe, A comparative Study*, 2004, no 733; E-M Kieninger, 'Securities in Movable Property within the Common Market' (1996) European Review of Private Law, 40–66, 47; E-M Kieninger, *Mobiliarsicherheiten im Europäischen Binnenmarkt*, 1996, 120; E-M Kieninger, 'Introduction: security rights in movable property within the common market and the approach of the study', in: *Security Rights in Movable Property in European Private Law*, E-M Kieninger (ed), Cambridge: CUP, 2004, 6–37, 16 et seq; W-H Roth, 'Secured Credit and the Internal Market: The Fundamental Freedoms and the EU's Mandate for Legislation', this issue, para II; JW Rutgers, *International Reservation of Title Clauses*, 1999, 205; A Veneziano, *Le garanzie mobiliari non possessorie*, 2000, 217 et seq; P von Wilmosky, *Europäisches Kreditsicherungsrecht, Sachenrecht und Insolvenzrecht unter dem EG-Vertrag*, 1996, 2 et seq.

3 K Kreuzer, 'La reconnaissance des sûretés mobilières conventionelles étrangères' (1995) 84 Rev. Crit. Dr. Internat. Privé 465–505, 504.

4 See Roth, n 2 above, para II. *Cf* Kieninger, n 2 above, 52.

5 See, inter alia, U Drobnig, 'A Subsidiary Plea: A European Contract Law for Intra-European Border-Crossing Contracts ', in: *An Academic Green Paper on European Contract Law*, S Grundmann, J Stuyck (eds), 2002, 343–351, 349 et seq; Kieninger, n 2 above, 215 et seq; Kieninger (2004), n 2 above, 22 et seq; E-M Kieninger, 'European Regulation of Security Rights', in: *Divergences of Property Law, an obstacle to the Internal Market?*, U Drobnig, HJ Snijders, E-J Zippro (eds), 2006, 165–171; HJ Snijders, 'Access to Civil Securities and Free Competition in the EU, a Plea for

the Treaty provides a competence with respect to the first three solutions mentioned above. Additionally, the institutional implications of different competences will be dealt with, as they play an important role in assessing which option is politically feasible. Finally, these considerations will be placed within the framework of the Common Frame of Reference process.

II. Competences within the Treaty

The European Community is only authorized to harmonise certain rules or create new instruments insofar as such competences are legally attributed to it (art. 5(1) EC).[6] As is well-known, the EC-Treaty does not contain a general competence to regulate the internal market, when there is merely a diversity of legal systems,[7] nor does it provide a general competence to harmonise private law or to create legal instruments in the private domain.[8] Therefore, recourse must be sought to other functional competences provided by the Treaty.[9] As Roth has

One European Security Right in Movables', in: *Divergences of Property Law, an obstacle to the Internal Market?*, U Drobnig, HJ Snijders, E-J Zippro (eds), 2006, 153–164, 156 et seq.

6 Opinion 2/94, Opinion pursuant to Article 228(6) of the EC Treaty, [1996] ECR I-1759, 1787. J Basedow, 'Codification of Private Law in the European Union: the making of a Hybrid' (2001) European Review of Private Law, 35, 43; A Dashwood, 'The Relationship between the Member States and the European Union/European Community' (2004) 41 Common Market Law Review 355, 357; G de Burca, P Craig, *EU Law, Text, Cases, and Materials*, 3rd edn, 2003, 122; Kapteyn VerLoren van Themaat, *Het recht van de Europese Unie en van de Europese Gemeenschappen*, zesde, geheel herziene druk, 2003, 115; S Weatherill, 'Recent developments in the law governing the free movement of goods in the EC's internal market' (2006) European Review of Contract Law, 90, 102.

7 Case C-376-98 *Germany* v. *European Parliament* [2000] ECR I-8419 para 84. See also, inter alia, Case C-434/02 *Arnold André GmbH & Co KG* v. *Landrat des Kreises Herford* [2004] ECR I-11825 para 30; Case C-210/03 *Swedish Match AB, Swedish Match UK Ltd.* v. *Secretary of State for Health* [2004] ECR I-11893, para 29; Case C-380/03 *Germany* v. *European Parliament and Council* [2006] ECR I-11573. Craig & de Búrca, n 6 above, 1185; W van Gerven, 'Bringing (Private Laws) Closer at the European level' in: *The Institutional Framework of European Private Law*, F Cafaggi (ed), 2006, 37, 39; Roth, n 2 above, para III 1; S Weatherill, 'European Private Law and the Constitutional Dimension', in: *The Institutional Framework of European Private Law*, F Cafaggi (ed), 2006, 79, 92.

8 W van Gerven, 'Codifying European Private Law: Top Down and Bottom up', in: *An Academic Green Paper on European Contract Law*, 2002, 405, 432; W van Gerven, 'Harmonization of private law: do we need it?', (2004) 41 Common Market Law Review 505, 506, 525; Weatherill, n 6 above, 101; S Weatherill, 'Diversity between National Laws in the Internal Market', in: *Divergences of Property Law, an Obstacle to the Internal Market?*, U Drobnig, HJ Snijders, E-J Zippro (eds), 2006, 131, 138.

9 Cf S Vogenauer, S Weatherill, 'The European Community's competence to Pursue the Harmonisation of Contract Law – an Empirical Contribution to the Debate', in: *The*

pointed out, potential candidates are Articles 65, 94, 95 and 308 EC.[10] Article 65b EC provides the power to harmonise conflict of law rules. Articles 94 and 95 EC are relevant with respect to the harmonization of substantive law rules. Article 308 EC provides a power which allows for the creation of a European Security Instrument.

Article 295 EC is often mentioned as an obstacle to the permeation of European law in the area of national property law, as it reads: "This treaty shall in no way prejudice the rules in Member States governing the system of property ownership". It follows from the ECJ case law that this provision neither precludes the harmonization of rules of substantive law in the area of property law nor the creation of a European Security Interest.[11] It is acknowledged that the large majority of the decisions deal with the issue whether national rules of property law are contrary to free movement. In answering this question the ECJ has held that property law is a matter of the Member States; however, that does not prevent the Court from assessing whether those national rules constitute an infringement of the free movements.[12] The result is that national property law also comes within the sphere of European law, which renders it suitable for harmonization, which will also follow from the discussion concerning Article 95 EC hereafter.

Prior to dealing with the requirements to adopt measures on the basis of Articles 65b, 95 or 308 EC, the different procedures to adopt a measure will first be discussed. They are relevant, since institutional players have not been hesitant to request judicial review of an adopted measure when they have lost the vote in the legislative process. These players have often tried to reassert their position through the Court.[13]

Harmonisation of European Contract Law, Implications for European Private Laws, Business and Legal Practice, S Vogenauer, S Weatherill (eds) 2006, 105, 106.

10 Roth, n 2 above, para VI. *Cf* D Staudenmayer, 'The Place of Consumer Contract Law within the Process on European Contract Law' (2004) 27 Journal of Consumer Policy 269, 279. However, Staudenmayer does not list Article 94 EC.

11 Case C-182/83 *Fearon* v. *Irish Land Commission* [1991] ECR I-1603; C-350/92 *Spain* v. *Council* [1995] ECR I-1985; Case C-423/98 Proceedings brought by A Albore [2000] ECR I-5965. With respect to industrial and commercial property: Case C-30/90 *Commission* v. *United Kingdom* [1992] ECR I-829. See also Rutgers, n 2, 175 et seq; Weatherill, n 8 above, 145 et seq.

12 Cf Kapteyn – VerLoren van Themaat, n 6 above, 554.

13 See for instance Case C-426/93 *Germany* v. *Council* [1995] ECR I-3723; Case C-233/94 *Germany* v. *Parliament and Council*, [1997] ECR I-2405, at 2412 (opinion Advocate General Leger); Case C-436/03 *Parliament* v. *Council* [2006] ECR I-3733; Case C-217/04 *United Kingdom* v. *Parliament and the Council* [2006] ECR I-3771; Case C-380/03 *Germany* v. *Parliament and Council* [2006] ECR I-11573. Craig & de Burca, n 6 above, 125; H Cullen, A Charlesworth, 'Diplomacy by other means: the use of legal basis litigation as a political strategy by the European Parliament and

Institutional complications occur when harmonised conflict of law rules are adopted on the basis of the Articles 61 to 68 EC. Such measures are adopted by qualified majority voting within the Council after having followed the co-decision procedure of Article 251 EC. However, not all Member States will be bound automatically (art. 69 EC).[14] The UK, Ireland and Denmark opted out of this part of the Treaty. The positions of the UK and Ireland differ from Denmark's. The former have the option of deciding with respect to each measure whether they will participate or not.[15] Denmark, however, does not have the possibility of opting in with respect to any individual instrument.[16]

Measures which are adopted under Article 95 EC require qualified majority voting in the Council after having followed the co-decision procedure of Article 251 EC and consultation of the European Economic and Social Committee. According to Article 308 EC, a measure must be adopted unanimously in the Council after mere consultation of the European Parliament. This implies that the position of any given Member State is stronger when the procedure of Article 308 EC is followed, since a sole Member State can block the adoption of a measure due to the unanimity requirement. The position of the European Parliament is rather weak, as it only has to be consulted.[17] However, when a measure is based on Article 95 EC, the European Parliament has, *inter alia*, the right of amendment, since the co-decision procedure of Article 251 EC must be followed.[18] Moreover, in a European Union of 27 Member States it will probably be hard to agree unanimously on issues concerning security interests. As a consequence, Article 308 EC is less attractive as a legal base when its feasibility is considered in a political context.

Member States' (1999) 36 Common Market Law Review 1243–1270; Weatherill, n 8 above, 138. *Cf* V Randazzo, 'note to Case C-217/04, United Kingdom v. European Parliament and Council of the European Union, judgment of the Grand Chamber of 2 May 2006, nyr' (2007) 44 Common Market Law Review, 155, 157.

14 See about this issue: J Basedow, 'The Communitarization of the Conflicts of Laws under the Treaty of Amsterdam' (2000) 37 Common Market Law Review, 687, 695 et seq; M Bogdan, *Concise Introduction to EU Private International Law*, 2006, 13; O Remien, 'European Private International Law, the European Community and its Emerging Area of Freedom, Security and Justice' (2001) 38 Common Market Law Review 53, 61 et seq.

15 Article 3 of Protocol (No 4) on the position of the United Kingdom and Ireland (1997) OJ 2006, C 321/198.

16 Article 7 of Protocol (No 5) on the position of Denmark (1997), OJ 2006, C 321/201–202. Basedow, n 14 above, at 696; Bogdan, n 14 above, 13.

17 Kapteyn, VerLoren van Themaat, n 6 above, 187. Cf Craig & de Burca, n 6 above, 126.

18 Kapteyn, VerLoren van Themaat, n 6 above, 329 et seq.

1. Articles 61–67 EC, Conflict of law rules

Articles 61–67 EC and in particular Article 65 b EC include the power of the European Community to harmonise conflict of law rules. However, harmonization of conflict of law rules with respect to the property law effects of security interests is not really an option, since the same conflict rule, the *lex rei sitae*, is applied in most Member States.[19] Moreover, the problems which occur do not only result from the *lex rei sitae*, the choice of law rule, but are also the effect of the closed system of real rights which is included in the substantive law of most legal systems to which the conflict rule refers.[20] In other words, harmonization of conflict of law rules will probably not solve the problem.

In short, harmonization of conflict of law rules does not provide a proper solution, since the same choice of law rule is applied in most Member States and it does not seem feasible that another conflict of law rule will be introduced. Moreover, measures adopted on the basis of the Articles 65b EC do not bind all Member States.

2. Articles 95 and 308 EC

After having established that the harmonization of conflict rules is not likely to solve the problems related to security interests in cross-border situations, only Articles 95 and 308 EC are left as a potential basis to harmonise security interests, or to create a European Security Interest. Article 94 EC will not be discussed, since it has become increasingly obsolete after the introduction of Article 95 EC in the Single European Act 1987.[21]

From the ECJ case law it follows that the two competences following from the Articles 95 and 308 EC are mutually exclusive.[22] Article 308 EC can only be applied when neither Article 95 nor any other Treaty provision provides a competence to adopt a measure.[23]

19 See: Drobnig, n 5 above, 348; P Mayer, V Heuzé, *Droit International Privé*, 2001, nr. 640 et seq; L Strikwerda, *Inleiding in het Nederlands privaatrecht*, 2005, nr 161; Veneziano, n 2 above, 221 et seq; von Wilmosky, n 2 above, 94 et seq.

20 See *inter alia*: Kieninger, n 2 above, 48; Roth, n 2 above, para II; Rutgers, n 2 above, 164 et seq.

21 Kapteyn – VerLoren van Themaat, n 6 above, 260; Weatherill, n 7 above, 84.

22 Case C-377/98 *Netherlands* v. *Parliament and Council* [2001] ECR I-7079, at 7157; Case C-436/03 *Parliament* v. *Council* [2006] ECR I-3733 para 36. See also Case 45/86 *Commission* v. *Council* [1987] ECR 1493 para 13; Case C-350/92 *Spain* v. *Council* [1995] ECR I-1985, at 2012.

23 Case C-377/98 *Netherlands* v. *Parliament and Council* [2001] ECR I-7079, at 7157; Case C-436/03 *Parliament* v. *Council* [2006] ECR I-3733 para 36. Craig & de Burca, n 6 above, 125.

The next question is what types of measures can be adopted according to Articles 95 and 308 EC. Article 95 (1) EC provides *inter alia*: "… the Council shall … adopt the measures for the approximation of the provisions laid down by law …" Article 308 EC only contains the phrase: "… the Council shall … take appropriate measures." Since these two provisions are mutually exclusive, as mentioned above, the instruments adopted on the basis of Article 308 EC cannot be the same as those adopted on the basis of Article 95 EC.[24] The ECJ has held that the content and the main object of a European measure are decisive in establishing the proper legal base.[25] Since Article 308 EC only comes into play when Article 95 EC does not provide a legal basis, it will at first be discussed to what extent Article 95 EC provides a legal basis to (i) to harmonise national rules concerning security interests and (ii) to create a new European security interest.

3. Harmonization of national rules concerning security interests

Article 95 EC provides that the Council shall adopt "… measures for approximation [which] … have as their object the establishment and the functioning of the internal market." According to the ECJ's case law it implies that a given measure has as "its purpose … to improve the conditions for the establishment and functioning of the internal market".[26] This is the case when there is either an obstacle to trade resulting from divergent national rules or a distorsion of competition. Thus, in these situations there is a power to harmonise a subject matter.[27]

The case law of the ECJ seems to confirm the view of Weiler that Article 95 EC is triggered as soon as there is an infringement of the free movements.[28] In other words, when an infringement of the free movement of goods is established, there is also a competence under Article 95 EC to re-regulate at a European level. This is different from the orthodox internal market doctrine, according to which the European Community only has the power to re-regulate insofar as an

24 See n 22.

25 Case C-300/89 *Commission* v. *Council* [1991] ECR I-2867; Case C-377/98 *Netherlands* v. *Parliament and Council* [2001] ECR I-7079; Case C-436/03 *Parliament* v. *Council* [2006] ECR I-3733 para 35.

26 Case C-217/04 *United Kingdom* v. *European Parliament and the Council* [2006] ECR I-3771, para 42.

27 Case C-376/98 *Germany* v. *Parliament and Council* [2000] ECR I-8419; Case C-380/03 *Germany* v. *Parliament and Council* [2006] ECR I-11573 para 67.

28 JHH Weiler, 'The Constitution of the Common Market Place: Text and Context in the Evolution of the Free Movements of Goods', in: *The Evolution of EU Law*, P Graig, G de Búrca (eds), 349, 362. See also Snell, n 1 above, 323 et seq. See for a different view: G Davies, 'Can Selling Arrangements be harmonised?' (2005) 30 European Law Review 370–385.

impediment of the free movements is justified by the grounds laid down in the Treaty or by the rule of reason as developed by the ECJ.[29] When an infringement does not pass the justification test, deregulation will merely take place according to this approach.[30] In other words, the national rules which constitute an impediment of one of the free movements must be set aside and no re-regulation will occur at a European level.

Thus, if a national measure results in an impediment of the free movement of goods, services or capital regardless of whether it is justified or not, the European Community may re-regulate at a European level. This is not merely a technical exercise; political choices must be made, as has been pointed out for instance in the Manifesto of a Social Justice Group.[31] Political issues which must be decided with respect to security interests are, for instance, who deserves better protection: i.e. the money lender or the goods supplier, and the ranking of harmonised rules within national legal systems.

In its Swedish Match decision the ECJ held that where there is a competence to harmonize a certain matter, other interests such as the protection of public health may also be decisive in establishing the harmonizing rule.[32] The question which arises is which interests can be taken into account: only those listed in the Treaty and those mentioned in the ECJ case law, for instance, or simply any general public interest. In the 2006 case, Germany v. European Parliament and the Council, the ECJ only refers to the former.[33]

Therefore, in order to assess whether the European Community has a power to harmonise security interests pursuant to Article 95 EC it must be established if and in which circumstances the rules relating to security interests result in an impediment of the free movement of goods, services or capital or a distortion of competition. Different views are expressed in the literature as to whether and

29 See Craig & de Burca, n 6 above, 1190, 1193; Weatherill, n 6 above, 100; Weatherill, n 8 above, 141; von Wilmosky, n 2 above, 7, 8.

30 See Craig & de Burca, n 6 above, 1190, 1193; Weatherill, n 6 above, 100.

31 Study Group on Social Justice in European Private Law, 'Social Justice in European Contract Law: a Manifesto' (2004) 10 European Law Journal 653–674. See also: Kreuzer, n 3 above, 504 ; KF Kreuzer, 'La propriété mobiliere en droit international privé', in: *Recueil des cours, collected courses of the Hague Academy of International Law 1996*, Tome 259, 1997, 253 et seq, 298; Weatherill, n 6 above, 101.

32 Case C-434/02 *Arnold André GmbH & Co KG* v. *Landrat des Kreises Herford* [2004] ECR I-11825 para 30; Case C-210/03 *Swedish Match AB, Swedish Match UK Ltd* v. *Secretary of State for Health* [2004] ECR I-11893, para 29; Case C-66/04 *United Kingdom* v. *Parliament and Council* [2005] ECR I-10553, para. 41 et seq; Case C-380/03 *Germany* v. *Parliament and Council* [2006] ECR I-11573 para 39 et seq, 95; JW Rutgers, 'The rule of reason and private law or the limits to harmonization ', in: *The Rule of Reason*, A. Schrauwen (ed), 2005, 145, 157; Weatherill, n 6, 90–111, 106.

33 Case C-380/03 *Germany* v. *Parliament and Council* [2006] ECR I-11573.

when national rules of private law and private international law result in an infringement of one of the free movements.[34] This will not be elaborated upon here.[35] Suffice it to say that in my view rules of private international law (choice of law rules) should be taken together with the rules of substantive law to which they refer when determining whether they constitute an infringement. Taking into account the ECJ case law and in particular the Dassonville decision, the test to be applied concerns the effect of a particular national rule on inter-state trade.[36] This also explains why it does not make sense to assess a conflict of law rule without taking into account the system of substantive law to which the rule refers, since in most European countries the prevailing view with respect to conflict of law rules is still the Savignian one.[37] In that respect, the only role which a conflict rule plays is to refer a legal relationship to a certain system of substantive law.[38] In other words, the content of substantive law to which the conflict of law rule refers is not taken into account. For instance, the choice of law rule relating to property law issues concerning movables is the *lex rei sitae*.[39] When goods are located in France, the application of the *lex rei sitae* implies that French law governs issues of property law with respect to those goods. The choice of law rule does not indicate any effects of the *lex rei sitae* on the free movements. Only when the content of French substantive law is also taken into account, it is possible to determine whether the *lex rei sitae* results in an impediment of trade.

In this respect the ECJ's decision Alsthom Atlantique is also relevant.[40] In an *obiter dictum*, the Court held that when parties have the possibility of selecting a legal system to govern their relationship, an infringement of the free movements cannot occur, since parties can contract independently of the mandatory rules of a given legal system. It should be remembered that a choice of law implies the application of both the mandatory and default rules of a given system of law. If this *obiter dictum* is translated to private international law situations, it implies that there may be an infringement of one of the free movements if, first, a mandatory choice of law rule (eg the *lex rei sitae*) applies or, second, a choice of law is set aside by the application of overriding mandatory rules (eg as provided in Article 7 of the 1980 Rome Convention) or, third, the public policy exception is applicable (eg as included in Article 16 of the 1980 Rome Convention).[41]

34 See Roth, n 1 above, para III 2, 3.
35 For an elaboration of these matters see Rutgers, n 2 above, 169 et seq; Rutgers, n 32 above, 150 et seq.
36 Case 8/74 *Dassonville* [1974] ECR 837; Weatherill, n 6 above, 90.
37 Strikwerda, n 19 above, nr. 19.
38 Mayer & Heuze, n 19 above, nr. 111;
39 Mayer & Heuzé, n 19 above, 640; F. Pocar, *Il nuovo diritto internazionale privato italiano*, seconda edizione, 2002, 59 et seq (nr. 22); Strikwerda, n 19, nr. 159.
40 Case C-339/89 *Alsthom Atlantique* v. *Compagnie de construction mécanique Sulzer SA* [1991] ECR I-107.
41 See eg Article 3 para 3 of the 1980 Rome Convention.

The question, of course, is whether Alsthom Atlantique is still valid law. Since decisions such as Überseering and Inspire Art do not contradict the *obiter dictum* in Alsthom Atlantique, there is good ground to argue that Alsthom Atlantique is still valid law.[42]

In the case of security interests in movables, a mandatory choice of law rule, the *lex rei sitae*, is applicable. In other words, parties are not allowed to agree upon the applicable law. The issue is whether this conflict rule together with the rules of substantive law constitutes an infringement of the free movements. It is generally accepted in the literature that the loss of a security interest which may be the result of the *lex rei sitae's* application together with the rules of substantive law constitutes a hindrance to the free movement of goods, services or capital.[43]

In this regard, Roth distinguishes between the moment of creation of the security interest on the one hand, and its enforcement on the other. In his opinion, the rules concerning the free movement of capital apply to the moment of creation and the rules concerning the free movement of goods and services to the moment of enforcement.[44] Therefore, the question is whether the application of the *lex rei sitae* can be divided in such a way that different free movement rules apply to the moment of creation and the moment of enforcement. The application of the *lex rei sitae* results in the distinction between the moment of creation and the moment of enforcement. The next question is whether, as a consequence of this distinction, different free movements can be subject to different parts of a national rule.

An infringement of the free movements will not occur when a national measure that constitutes an obstacle to trade is justified by one of the grounds mentioned in the Treaty or the rule of reason as developed by the ECJ.[45] This justification test will be discussed later, since, as explained above, according to some Article 95 EC only provides the power to harmonise when a national measure which results in an impediment of the free movement of goods or services passes this test. To do so, national rules must be proportionate and necessary to protect certain interests.[46] In its case law, the ECJ has accepted the transparency and predictability of a mortgage system[47] and the protection of certain creditors[48] as overriding mandatory requirements.

42 Case C-212/97 *Centros* [1999] ECR I-1459; Case C-208/00 *Überseering* [2002] ECR I-9919; Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam* v. *Inspire Art Ltd*. [2003] ECR I-10155.

43 See, *inter alia*, Kieninger, n 2; Roth, n 2 above, IV 2; Rutgers, n 2 above.

44 Roth, n 2 above, IV.

45 About these justifications see: Barnard, n 1 above, 65 et seq, 115 et seq.

46 Barnard, n 1 above, 81 et seq, 119 et seq.

47 Case C-222/97 Proceedings brought by M Trummer and P Mayer [1998] ECR I-1661, at 1680.

48 Case C- 212/97 *Centros* [1999] ECR I-1459; Case C-208/00 *Überseering* [2002] ECR I-9919; Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam* v. *Inspire Art Ltd*. [2003] ECR I-10155.

The arguments of predictability and transparency are closely linked to the *numerus clausus* of real rights. The rationale of the *numerus clausus* is *inter alia* that (third) parties should only have to consider a certain number of real rights which can encumber the goods in a given national territory. A means to identify those real rights is the doctrine of publicity, which aims at providing transparency and predictability. However, this notion of publicity is not always applied consistently. Parties and creditors only have to be aware of real rights which are available under the legal system of a country. Considering this, the *numerus clausus* of real rights may arguably also be considered a mandatory reason justifying the application of certain rules. However, insofar as there are other types of non-possessory security interests which are not registered in a certain legal system and therefore remain invisible, it is questionable whether the *numerus clausus* will meet the proportionality and necessity requirements. This must be assessed in each individual case.

Roth also considers the Krantz judgment in the context of mandatory requirements and argues that in the Krantz decision, the ECJ probably wanted to avoid the discussion concerning mandatory requirements.[49] In that decision, the ECJ held that the Dutch rules concerning seizure by tax authorities in bankruptcy procedures are too remote and too indirect to constitute an infringement of the free movement of goods. In other words, the Dutch rules do not fall within the scope of the free movement of goods. However, this decision is rendered in the wake of Keck and it may be regarded as foreboding Keck and the ECJ's subsequent case law.[50] In Keck, the ECJ distinguishes between selling arrangements and product requirements;[51] the latter fall within the scope of Article 28 EC (the free movement of goods). Selling arrangements, however, only fall within the scope of Article 28 EC insofar as they are discriminatory in law and in fact. From subsequent case law, commentators infer that the national measure at stake must aim at regulating cross-border trade and not just any inter-state trade, or differently put, they must prevent access to the market.[52] If this is applied to the Krantz case, the Dutch national rules concern selling arrangements. Moreover,

49 Case C-69/88 *H Krantz GmbH & Co.* v. *Ontvanger der Directe Belastingen and Staat der Nederlanden* [1990] ECR I- 583. Roth, n 2 above, V 1b; *Cf* J Snell, *Goods and Services in EC Law, A Study of the Relationship between the Freedoms*, 2002, 72 et seq.

50 Cf Barnard, n 1 above, 139 et seq.

51 Case C-267/91–268/91 *Keck and Mithouard* [1993] ECR I-6097. See about Keck *inter alia*: Barnard, n 1 above, 143 et seq; P Oliver, S Enchelmaier, 'Free Movement of Goods: Recent Developments in the Case Law' (2007) 44 CMLRev. 649, 672 et seq.

52 P Oliver, W-H Roth, 'The internal market and the four freedoms' (2004) 41 CMLRev. 407, 413 et seq; M Poiares Maduro, 'Harmony and Dissonance in Free Movement' (2001) 4 *The Cambridge Yearbook of European Legal Studies*; A Dashwood et al. (eds) 315, 331 et seq. See about other distinctions of national rules on the

those rules neither discriminate in law or in fact nor do they aim at regulating cross-border trade. Taking all this into account, the Dutch rules concerning seizure would probably not fall within the scope of Article 28 EC taking into account Keck and its subsequent case law.

In short, it is arguable that the *lex rei sitae* together with the rules of substantive law to which the *lex rei sitae* refers in the case of a loss of a foreign security interest results in an infringement of the free movements. Consequently, there is a power for harmonization pursuant to Article 95 EC.

4. European Security Interest

It is difficult to establish on an abstract level whether the creation of a European Security Interest should be based on either Article 308 EC or Article 95 EC, since according to the ECJ case law, the content and the main object of a European measure are decisive and at present they are still unknown. Nevertheless, some characteristics of a European Security Interest can be inferred from the literature. Dirix, for instance, writes: "A security device that would not withstand the entitlement of other creditors or the administrator of an insolvency proceeding simply cannot qualify as a security right."[53] Thus, to be effective, a European Security Interest should be enforceable vis-à-vis third parties in and outside bankruptcy proceedings. In addition, its ranking among other national security interests must be known.[54]

With respect to the creation of a European Security Interest which coexists with national security instruments, the ECJ decisions with respect to the Community Trade Mark[55] and the European Cooperative Society (ECS)[56] are relevant.[57] These instruments can be compared to a European Security Interest, since

basis of Keck and its subsequent case law: Barnard, n 1 above, 137 et seq; P Oliver, W-H Roth, 'The internal market and the four freedoms' (2004) 41 CMLRev., 407, 414; Roth, n 2 above, IV 2a.

53 E Dirix, 'Effect of Security Rights vis-à-vis Third Persons', in: *Divergences of Property Law, an Obstacle to the Internal Market?*, U Drobnig, HJ Snijders, E-J Zippro (eds), 2006, 68, 68. See also: Kieninger, n 5, above, 166 et seq; Veneziano, n 2 above, 316.

54 *Cf* Kieninger, n 5, above, 166 et seq; G Monti, G Nejman, W Reuter, 'The Future of Reservation of Title Clauses in the European Community' (1997) International Comparative Law Quarterly, 866, 896.

55 Council Regulation EC No 40/94 of 20 December 1993 on the Community trade mark, OJ 1994 L 11/1-36.

56 Council Regulation EC No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE) OJ 2003 L 207/1-24.

57 Case C-377/98 *Kingdom of the Netherlands* v. *European Parliament and Council* [2001] ECR I-7079, 7157; Case C-436/03 *Parliament* v. *Council* [2006] ECR I-3733;

they all concern private law instruments at a European level. Moreover, they exist in addition to national types.[58] The ECJ has held that Article 95 EC does not provide the proper legal basis to create such instruments, and that Article 308 EC should have been applied instead.[59] With respect to the Community Trade Mark and the European Cooperative Society, the ECJ has held that Article 308 EC is the proper legal basis, since the European measures created a new Community Trade Mark and a new European Cooperative Society in addition to the national ones. The European rules which establish the new European private law instrument do not have to be exhaustive, they can also refer to national law provided that this referral concerns minor issues.[60]

In order to have a competence pursuant to Article 308 EC, this provision requires that the Treaty has not provided any other necessary powers to create a European Security Interest.[61] Neither Article 95 EC nor any of the other Treaty provisions do so. In addition, a measure adopted under Article 308 EC must aim at attaining one of the objectives of the internal market, which are listed in Articles 2 and 3 of the Treaty.[62] Article 3(1) c includes an internal market without any impediments for the free movements of goods, services, capital and persons.[63] Since, as explained above, the *lex rei sitae* together with the *numerus clausus* of real security rights may result in a loss of a security interest in the case of cross-border trade, this risk could be regarded as contrary to the free movement of goods, services or capital and consequently as an obstacle to the common market.[64] In other words, a European Security Interest will aim at the removal of obstacles to trade and as a result aim at achieving one of the objectives of the internal market.

Cf Opinion 2/94, Opinion pursuant to Article 228 (6) of the EC Treaty, [1996] ECR I-1759, at 1788. Cf J Basedow, 'Ein optionales Europäisches Vertragsgesetz – opt-in, opt-out, wozu überhaupt?' (2004) 12 Zeitschrift für Europäisches Privatrecht, 1 et seq.

58 Cf Also the European company (SE) Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European Company (SE) OJ 2001, L 294/1.

59 Case C-436/03 *Parliament* v. *Council* [2006] ECR I-3733

60 Case C-436/03 *Parliament* v. *Council* [2006] ECR I-3733 para 45.

61 Craig & de Burca, n 6 above, 125.

62 Cf Opinion 2/94, Opinion pursuant to Article 228(6) of the EC Treaty, [1996] ECR I-1759; Case T-315/01 *Yassin Abdullah Kadi* v. *Council and Commission*, CFI [2005] ECR II-3649 nr. 100 et seq with note by C. Tomuschat (2006) 43 *CMLRev*., 537–551.

63 *Cf* Kapteyn – VerLoren van Themaat, n 6 above, 185

64 S Vogenauer, S Weatherill, 'The European Community's competence for a comprehensive harmonisation of contract law – an empirical analysis' (2005) European Law Review, 821–837, n 23.

5. Conclusion

In short, whereas Article 95 EC provides a competence for harmonizing rules concerning security interest, Article 308 EC provides one to create a European Security interest that exists in addition to national security instruments.

III. CFR Process

As is well known, the European Commission has published a number of policy documents concerning the future of a European Contract Law.[65] The term "contract law" is a rather vague notion in these documents. It "… encompasses several areas of law. […] The areas concerned by this Communication include contracts of sale and all kinds of service contracts, including financial services. […] Furthermore, because of the economic context, rules on credit securities regarding movable goods…may also be relevant."[66] After public consultation and having considered several instruments and possibilities, the European Commission announced the continuation of the elaboration of two instruments in its first annual progress report: (i) a Common Frame of Reference[67] and (ii) an optional instrument also known as a non-sector-specific instrument. The latter instrument is a body of rules that parties can select to govern their cross-border transactions or, in other words, an opt-in instrument.[68]

The CFR is a non-binding instrument, at least for the time being, which is described as a toolkit.[69] It serves to improve the existing acquis and to provide more coherence in future Community measures.[70] It therefore contains a reservoir of rules, definitions etc., which the European Commission can use if it wants to initiate new legislative measures.

At the time of writing this paper, academics prepare a draft CFR, which has not yet been made public. Therefore, no comments can be made on the rules which are to be included in the draft CFR. In the Communications of the

65 Communication on European Contract Law, Com (2001) 398 final. Communication A more Coherent European Contract Law, An Action Plan, *OJ* 2003/C 63/01. Communication the Way Forward, COM (2004) 651 final.

66 Communication on European Contract Law, Com (2001) 398 final nos. 12, 13.

67 Hereafter: CFR.

68 Communication the Way Forward, COM (2004) 651 final, 18. *Cf* D Staudenmayer, 'The Way Forward in European Contract Law' (2005) European Review of Private Law, 95, 100 et seq.

69 Communication the Way Forward, COM (2004) 651 final, 14. Staudenmayer, n 68 above, 99.

70 Communication, A more coherent European Contract Law, An Action Plan, *OJ* 2003, C 63, no 59 et seq. Staudenmayer, n 68 above, 96.

European Commission, reference is made to security interests, a retention of title clause in particular and the problems which occur in cross-border trade in this respect.[71] However, no words are devoted to a European Security Interest, which may have the form of an optional instrument as discussed by the European Commission in its discussion papers. In that form it would be a European Security Interest that co-exists with security interests pursuant to national law, which parties can choose instead of a national security interest and which will be enforceable against third parties within and without bankruptcy proceedings.

Despite strong calls for a European Security Interest or harmonized rules concerning security interests within legal literature, the European Commission has focused mostly on contract law rather than the law relating to security interests. Considering the Commission's policy documents, it is likely that this will not change in the near future.

IV. Conclusions

The EC Treaty includes a power to create a European Security Interest on the basis of Article 308 EC. However, the institutional disadvantages of this option are that the Council has to decide unanimously after mere consultation with the European Parliament. In the legal literature, the creation of a Security Interest seems to be favoured. However, harmonization of security interests on the basis of Article 95 EC is more attractive from an institutional perspective. Such measures can be adopted on the basis of qualified majority voting in the Council after consultation of the European Economic and Social Committee and after having followed the co-decision procedure of Article 251 EC.

71 See about the relation between a European Security Interest and the CFR-process: JW Rutgers, 'Harmonisation of Security Interests and the Communications on Contract Law', in: *Divergences of Property Law, an obstacle to the Internal Market?*, U Drobnig, HJ Snijders, E-J Zippro (eds), 2006, 217–227.

Choosing the Right Approach for European Law Making

by

Robert H Stevens*

Table of Contents

I. Introduction

Few topics can be of more practical relevance than cross border security. However, in this paper I wish to argue for less pragmatism and more principle. My primary purpose will be to show how some of the perceived problems with taking security across borders can be overcome. My subsidiary purpose is to suggest that legislative intervention at a European level is almost certain to make matters worse, adding greatly to commercial risk.

In this paper I shall, without apology, adopt the perspective of a common lawyer. I shall try to explain to a civilian audience what is *conceptually* distinct about "equitable rights" within the common law, and how this has important implications for international transactions, especially in relation to cross border security. Unfashionably, I wish to argue that we need to pay more attention to the legal nature of a transaction, rather than to its commercial effects or functions. Practical commercial people want rules which are certain and work in practice. This can only be achieved by carefully clarifying our legal concepts and doctrine. The alternative is an ever increasing number of transaction specific rules, with consequent incoherence, uncertainty and inflexibility.

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II. The Problem

X Ltd wishes to borrow from Y Bank. Y Bank is prepared to lend but only if it is able to take security over all of X Ltd's assets, present and future. The physical assets to which X Ltd has title to, both movable and immovable, are situated in a number of jurisdictions, each of which has differing requirements for the successful transfer of rights to things. The movable things have the inconvenient habit of moving, so that it is unknown where each particular asset is currently situated, or will be situated when acquired. Worse, the intangible assets are governed by a diverse range of differing laws. Some of the receivables are by their terms, or under their governing law, incapable of transfer. Some of X Ltd's securities are only transferable by the alteration of a register.

In order to create a valid security over all of these rights it would be, to say the least, inconvenient to require Y Bank to take advice relating to the transfer of rights and the creation of security in relation to all of the actual or potential legal systems governing the underlying rights. Further, the diverse requirements before transfer can be affected, whether of form, notice or registration, to which each of these rights is potentially subject, add greatly to the practical difficulty and cost. Where there is more than one security right created in favour of different lenders, the difficulties and inconsistencies involved in having priorities determined by these disparate laws, which for some assets change overtime, are obvious.

Of course X Ltd and Y Bank can have their agreement governed by any law they choose, but this will only determine their rights *inter se*. For most purposes, however, it is the proprietary effect of what they have agreed which is of importance. How is this to be determined?

1. Rights to Things and Rights to Rights

Like many others, in the past when I have been asked to explain the nature of equitable proprietary rights in general or trusts in particular to a civilian lawyer, I have resorted to a history lesson. Once upon a time, England had courts of law. Unfortunately the types of claim they would hear became increasingly ossified. Claims could also be heard by petitioning the king, who delegated his power to hear such petitions to the Lord Chancellor. Over centuries the Chancellor's jurisdiction developed into a rival legal system, the Courts of Chancery, with a separate body of law called Equity. Two parallel court systems within one jurisdiction.

Eventually Equity recognised the trust. An item of property such as an area of land may be owned at common law by one party, but if he holds it on trust for another, the other is the "beneficiary" or "equitable owner". Textbooks com-

monly refer to ownership being "divided" between the legal owner and beneficial owner.[1]

At around this point in the story I can see my listener's eyes begin to glaze over. Modern lawyers, particularly from civilian jurisdictions, are rightly less interested in a history lesson, however charming, than in the practical significance of the distinction between law and equity. In the United States the jurisdictional divide is now largely forgotten. When a civilian lawyer is further told that in all modern day common law jurisdictions there are no longer two court systems, so that Law and Equity are administered in the same courts, with the equitable rules prevailing in the case of conflict, they could be forgiven for losing interest altogether, and may seek to move the conversation on to more interesting topics, such as the minutiae of the rules of cricket.

That there is something wrong with the historical account given above should be obvious. How, in any single jurisdiction, could it be possible for there to be two sets of courts with different rules for determining the ownership of things, so that one party could be the "legal" owner, and another the "equitable" owner? How can any legal system function which gives two different answers to the question "Who owns Blackacre?"

The short answer is that no legal system could sensibly operate in such a way.

The importance and commercial significance of equitable rights can only be explained by their conceptual distinctiveness, not their historical provenance. Further, common lawyers need to be able to give a conceptually attractive account of their law, shorn of the language of the long dead jurisdictional divide, if they are to have any hope of persuading lawyers from non-common law jurisdictions that they have rules of law which could be usefully adopted by their legal systems or by international conventions.[2]

If X, the owner of Blackacre, declares a trust over his right to the land in favour of Y, Y has no right to the land itself. It is a common misconception to

1 Eg M Bridge, *Personal Property Law* (2002, 3rd ed) 11, 31; R Goode, *Commercial Law* (3rd ed, 2004), 38.

2 It has been argued that the trust involves the creation of a separate or special patrimony, a concept found within Civilian jurisdictions. See P Lepaulle, *Traité théorique et pratique des trusts en droit interne, en droit fiscale et en droit international* (Paris: Rousseau et Cie, 1931) and G Gretton, "Trusts Without Equity" (2000) 49 I.C.L.Q. 599. Whilst this may accord with the Scottish conception of the trust (eg K Reid, "Patrimony Not Equity: the Trust in Scotland" (2000) 8 European Rev. of Private Law 427; Scottish Law Commission, *Discussion Paper (No. 133) on the Nature and the Constitution of Trusts* (Edinburgh: The Stationery Office, 2006) at 10–13) it is simply wrong with respect to the common law (P Matthews, "From Obligation to Property, and Back Again? The Future of the Non-Charitable Purpose Trust" in D Hayton, ed, *Extending the Boundaries of Trusts and Similar Ring-Fenced Funds* (The Hague: Kluwer Law International, 2002) 203, 213–216). Only rights can be the subject matter of a trust, never liabilities.

perceive legal and equitable rights as like a Russian doll, with the equitable right being a miniature version of the legal right stuffed within it. Equity did not, and does not, confer rights to things but rights to other rights. Y has a right to X's right to Blackacre, but no right to Blackacre itself. The subject matter of Y's equitable right is another right. There are not, and cannot be, two different incompatible answers to the question "who owns Blackacre?"

What is the difference and why does it matter? In order to answer this question it is necessary to analyse what we mean by "property rights". Such rights have a number of characteristics, none of which is a necessary characteristic of all rights so described. A simple definition of what this family of rights has in common, which would accord with all usages, is therefore unobtainable.

For a common lawyer, a core example of a property right is a tenant's interest in premises under a lease. The tenant's right has a number of characteristics which members of the family of property rights frequently possess.

One characteristic of the property rights which a tenant's right under a lease usually possesses is that the right itself is capable of transfer. A leasehold interest can be sold, bequeathed or given away. Not all "property rights" share this characteristic. Some "property rights" are also inalienable. For example, the right to run a market may be incapable of transfer or it may be a term of a lease that the tenant cannot assign it. Equitable rights are commonly transferable, although English law sometimes requires that this be done in a particular form.[3]

A second characteristic of a property right, which a leasehold interest has, is that it is exigible against the rest of the world (*erga omnes*). Property rights are the category most lawyers first think of when asked to describe a right good against everyone else. Other rights also have this characteristic, such as my right not to be slandered or not to be detained against my will. Exigibility against the rest of the world in relation to a right to a thing distinguishes a right *in rem* from a right *in personam*. If I own a car no one can take it from me without my consent. Further than this, others must take care not to damage my car. I have the same rights in relation to my car exigible against every other person. My right that you do not damage my car is not absolute; if my car is unintentionally damaged without fault I have no claim.

We sometimes confer the label "property rights" upon rights which do not share the characteristic of exigibility against every other person. "Property" is sometimes used in a broader sense of wealth. For example, all of a company's receivables (i.e. the claims it has against others) are referred to as a company's property for the purposes of the insolvency legislation.[4] The rights of a beneficiary under a trust do not have the characteristic of exigibility against the rest of the world. If a legal estate to land is held on trust the beneficiary has a right to the

3 Law of Property Act 1925, s 53(1)(b).
4 Insolvency Act 1986, s 436.

legal owner's right to the land, but no right good against anyone other than the rightholder from time to time. So a beneficiary under a trust has no standing in her own name to sue a squatter in the tort of trespass. Similarly, if a car is held on trust, the beneficiary will not have standing to sue a thief in the tort of conversion as her right is not exigible against the thief. This is not simply a matter of the equitable right being "invisible" to a common law court. The beneficiary has no claim in her own name at all, whether in law or in equity. The beneficiary has no direct right to the tangible asset itself good against the rest of the world, but merely a right to the trustee's right. *In this sense,* equity acts *in personam*, and does not create rights to things exigible against all others. All the beneficiary can do in these situations is compel the owner of the thing to enforce the rights that he has, and holds for the beneficiary.

A third characteristic that "property rights" commonly have is that the right is in relation to a subject matter which can be transferred independently of the right itself but in relation to which the right can persist after transfer. So, if the landlord sells the premises, the tenant's right under the lease will persist after sale and is capable of binding the purchaser. A beneficiary under a trust has a property right *in this sense*, although the subject matter of the beneficiary's right is not a physical thing such as a house but the trustee's right or rights. If a trustee transfers his right to someone other than a *bona fide* purchaser for value without notice of the beneficiary's right, the beneficiary's right persists in relation to the right transferred. The beneficiary can assert his right to the (legal) right directly against a transferee but has no right, in his own name, against the squatter or thief as the trustee's right is not transferred to them. Similarly, where a trustee goes into bankruptcy, the beneficiary's right to the right(s) of the trustee will persist, so that those rights held on trust do not form part of the bankrupt's estate available for realization and distribution to creditors.

If therefore a trustee of a car transfers his title to someone other than a *bona fide* purchaser for value, the transferee will hold the right to the car on trust for the beneficiary. The beneficiary can sue the transferee in her own name, without the need to join the original trustee. Unlike the thief or squatter, the transferee acquires the trustee's right, and the beneficiary may continue to assert her right to that right as against the transferee.

The difference between the characteristics of general exigibility and persistence may be illustrated by contrasting intellectual property rights with the rights of a beneficiary under a trust. The characteristic of persistence is not found in relation to intellectual property rights, as these rights have no subject matter independent of the right itself, which is capable of separate transfer. However, as intellectual property rights are exigible against the rest of the world, no one may infringe my patent or breach my copyright. By contrast, the rights of the beneficiary under a trust are only exigible against the right-holder from time to time. The range of rights which can be held on trust is very broad, not just rights to

things but also debts, shares and many other rights. This is a yet further demonstration that the subject matter of the beneficiary's equitable right is another right not a thing. When the subject matter of the beneficiary's right, the trustee's right, is transferred away it will persist against the transferee, unless he is a *bona fide* purchaser for value without notice.

If I am owed a debt, I do not have a right which is exigible against anyone other than the debtor.[5] Further my right to be paid has no subject matter which is capable of transfer independently of the right. If I declare myself a trustee of the debt in favour of a beneficiary, the beneficiary's right against my right is also not exigible against the whole world. However, the beneficiary's right has a subject matter, here the debt, which will, potentially at least, persist in relation to that debt if the debt is transferred away by me. It is in this sense that the beneficiary under a trust has a proprietary right, although the creditor does not.

There is no necessary reason why the subject matter of the beneficiary's right must be a common law right. The beneficiary's right may also be held on trust. So, there may be sub-trusts, and sub-sub-trusts and sub-sub-sub-trusts and so on. If a metaphor is thought useful, the correct one is not a Russian doll but a series of links in a chain, each link being a right attached to another right.

Where there is no other person with a right to my right, there is no "equitable" or "beneficial" interest involved. I am simply the owner of the computer on which I am currently writing, I do not have a "beneficial" or "equitable" right to the computer. Equitable rights are not stuffed within legal title, like (equitable) sausage meat stuffed inside a (legal) skin.

The genius of equity, and I do not consider this to be too strong a word, was to allow the creation of rights to other rights. The common law did not create rights to other rights. No doubt this development in equity was made possible by the jurisdictional divide, but clinging to an account of the common law which places emphasis on its peculiar history disguises both how clever it is, and how commercially useful. It also shows how other jurisdictions, with quite different histories from that of England, could adopt the same conceptual approach.

2. Mortgages and Charges

The distinction between rights to things and rights to other rights is reflected in the difference between mortgages and charges. If I own a fleet of cars and mortgage them to a lender, the right to the cars are transferred to the lender. All

5 I do have a right against all others that they do not procure the breach of the contractual obligation, but this is observably a different right from the right I have against the debtor. Similarly, a beneficiary under a trust has a right against all others that they do not dishonestly assist in a breach of trust, but this is, again, observably not the same right as the right against the trustee from time to time.

I have is an equity of redemption, which entitles me to the re-conveyance of title to the cars upon repayment.[6]

If instead of mortgaging the cars I create a charge in favour of the lender, there is no transfer of rights to the lender. Charges were, and are, only possible in equity because they involved the creation of a right to the right secured, not a transfer of the underlying right. A charge differs from a trust because the chargee's right to the chargor's right is defeasible upon the chargor paying what he owes. The chargee only has a right to the right charged, to the extent that he remains unpaid. Crucially, the chargor unlike a trustee does not hold the right for the benefit of the chargee, but merely by way of security. Functionally, a charge does not differ from a mortgage, but it is only conceptually possible in a system which allows rights to other rights. All charges operate in this manner, whether fixed or floating. The *conceptual* divide between a fixed charge and a mortgage is greater than that between a fixed and floating charge.[7]

Mortgages and charges are alike in the sense they are security rights, unlike a beneficial interest under a trust or a fee simple which are indefeasible entitlements. Trusts and charges are alike in the sense that they involve rights against other rights, unlike a mortgage or a fee simple which do not. We need to keep separate our different methods of dividing rights for different purposes. An analogy may be drawn with the natural world. Cats and alligators are alike as both are carnivores, unlike pandas and iguanas which are herbivores. Cats and pandas are alike as both are mammals, unlike alligators and iguanas which are reptiles.

The chargee's right shares with the right of a beneficiary the characteristic of persistence. If the charged assets are given away, or if the chargor goes into bankruptcy, the chargee's rights will persist. Again the chargee's right is only exigible against the holder of the rights charged from time to time.

A charge does not, however, have many of the other features a trust commonly has. Many trustees are also under fiduciary obligations, a duty to subordinate their interests to those of the beneficiary. If I declare a trust fund in favour of my children, I must administer the trust for their benefit, not mine. However, these fiduciary obligations are not found in relation to all trusts. For

6 As its name implies, the equity of redemption is another equitable right. It too has the characteristic of persistence if title to the cars are transferred away by the lender. See, for example, *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638, [1403] *per* Lewison J.

7 Technically, a floating charge does not involve (claim) rights to the rights within the charge's scope but merely a power to create such rights. All rights within the scope of such a charge are subject to this (proprietary) power, which, again, may persist against someone who acquires a right from the debtor outside of the ordinary course of business and who is not a *bona fide* purchaser for value. (These powers are commonly, if unhelpfully, referred to as "mere equities".) The power is a fragile creature, however, and will not take priority over a subsequent fixed charge, which does involve the creation of a present right to a right.

example, if I transfer title to my house into the name of a stranger, a resulting trust will arise over his title to the house. The stranger, who may be wholly ignorant of the transfer, is under no fiduciary obligations to me. These obligations are not part of the "core" definition of a trust.

It is frequently commented that common law systems are generous in the ability they confer upon lenders to create security. Tangible and intangible assets, present and future, may all be subject to security which may be of an all-embracing kind, without the necessity of specifying precisely the assets within its scope. I would suggest that the reason for this generosity is not to be found in any conscious policy choice. English law is, in this area, judge made law. Although the legislature has, in many ways, intervened by, for example, requiring the registration of certain types of charge, the law's structure is the creation of the judges. It was the intellectual leap of allowing rights to other rights which enabled inventive transaction lawyers to draft agreements creating all embracing security rights. No doubt this leap was caused by English law's peculiar history, but the history is of little practical relevance. It was this concept which allowed the creation of inventive forms of commercial transactions, of which securitization is just one modern day example. It is interesting to *assess* the law from the perspective of economic theory or social policy, but it cannot be *understood* from such standpoints.

3. Commercial Significance

a) Intangible Movables

An example:

> S Ltd, a timber merchant, assigned to F Ltd, a factoring company, its right to receive £1,000 from B, a purchaser of timber. The contract between S Ltd and B was concluded on B's written standard terms of business, which contained a clause prohibiting S Ltd from assigning its rights. S Ltd goes into insolvent liquidation after the timber has been supplied, but before B has paid.

It is inherent in S Ltd's right to be paid £1,000 by B that it is incapable of transfer. Any purported transfer of the underlying right will not, therefore, be effective.[8] F Ltd may have a claim for breach of contract as against S Ltd for failing to fulfill its obligation to transfer, but this may be of little value as it will be an unsecured claim which F Ltd must prove for in the liquidation of S Ltd. The debt remains owed to S Ltd.

8 *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 AC 85.

However, the mere fact that a right is incapable of transfer does not prevent the creation of a right to that right. If, therefore, S Ltd declares a trust over the right to be paid by B, in favour of F Ltd, this will be valid and effective.[9] B still owes the money to S Ltd, and will obtain a valid discharge by paying S Ltd even after the declaration of trust. However, the prohibition on assignment does not invalidate the declaration of a trust, or the creation of a charge, over the underlying right, as these equitable rights do not involve any transfer of the underlying right to which they relate.[10] Upon S Ltd's liquidation the right to be paid by B will not therefore form an asset freely available for the purposes of distribution to unsecured creditors. Even if the contract between B and S Ltd prohibited the creation of a trust, or charge, this would not invalidate the creation of such rights. It would be a breach of contract for S Ltd to create such a trust, or charge, just as it would be if it had agreed with a third party not to create such rights over its tangible assets,[11] but as there is no transfer of the underlying right the trust, or charge, is valid.

Similarly, if a company wishes to use securities which are transferable only by registration for the purposes of securing a loan, and if this could only be done by way of mortgage, it would be necessary to have the register altered in order to transfer the right to the securities to the lender. However, it is perfectly possible to create a trust or charge over the securities, without transferring the underlying right.[12] The beneficiary or chargor has a right to the right. The underlying right is unaffected.

Precisely the same problem may arise in a cross-border context. The law governing an obligation determines to whom it is owed. If the debt owed by B is non-assignable not because of its terms but because the law governing the underlying debt does not permit transfer, this should prevent the transfer of the underlying right. However, this does not prevent the ability to create a right to that right, whether by way of trust or charge. Just as equitable rights may have as their subject matter rights recognized or created by common law courts, they may have as their subject matter rights sourced in German, French or Peruvian law.

It is because of the ability to create rights to other rights that the securitisation market originated and was possible in the common law world. In a typical securitisation, an originating company which is owed receivables sells them to a Special Purpose Vehicle which funds the purchase through the issuing of securi-

9 Compare the crude prohibition on non-assignment clauses contained in the US Article 9-401(b).

10 *Barbados Trust Company Ltd v Bank of Zambia* [2007] EWCA Civ 148 [43] *per* Waller LJ.

11 This most common in the context of security rights where a "negative pledge" clause prohibits the creation of further security.

12 *Don King Productions Inc v Warren* [2000] Ch 291.

ties in the market. It is essential for a securitisation to be effective that the Special Purpose Vehicle is guaranteed the income from the receivables, and is not exposed to the risk of the originating company's insolvency. This could not be achieved if it was always necessary to have an outright transfer of all of the underlying receivables. Debts which are by their terms or by their governing law non-assignable cannot be transferred. However, by conferring upon the Special Purpose Vehicle a right to the underlying rights the income stream is guaranteed without the necessity of transfer.

Even if, as in England but not the United States, the securitisation purports to take effect by way of absolute transfer, this does not prevent the operation of a trust as a default where such absolute transfer fails. Equity will save the transaction because all rights to other rights operate as a lasso, and have the characteristic of persistence. If, for example, there is an agreement to sell land, equity will raise a trust over the land prior to the conveyance. The same rule applies to other rights, such as receivables and registrable securities which similarly cannot be transferred by agreement alone. In relation to receivables, notice to the debtor is necessary, for registrable securitites the alteration of a register. In relation to goods, the same rule does not apply because of the ability to pass title to the goods by way of agreement alone, which is one of the peculiarities of the common law. There could only ever be a trust over goods sold, from the moment at which the buyer has a right to their transfer. If, therefore, there is an agreement to sell goods on 1 April with title to pass on 1 September, there can be no trust prior to 1 September as prior to that date the contract confers no right to the goods. Upon 1 September legal title to the goods will pass, leaving no room for the creation of a trust.

It is sometimes said that the trust which arises when it is agreed to sell land arises from the maxim that "equity takes as done what ought to be done". However, this can mislead as it would indicate that where what ought to be done, transfer, cannot be done, because, for example, the underlying debt assigned is expressly non-assignable, that no trust would arise.[13] This is incorrect. It is more accurate, if less catchy, to say that whenever X has a right to Y's right, X's right has the characteristic of persistence if Y's right is transferred away. It does not matter whether X's right is created by contract, unjust enrichment, a wrong committed by Y, or for any other reason.

In France, Germany, Italy and Luxembourg legislative steps have been taken to attempt to facilitate securitisation. In common law systems, no such legislation was or is necessary.

Allowing the creation of rights to rights in this way does not prejudice the position of the debtor. So far as he is concerned, the claim against him is unaltered and any defences he can assert against the creditor remain.

13 A Tettenborn [2001] LMCLQ 472.

The holding of securities through a series of intermediaries is also explained by the employment of sub-trusts, sub-sub-trusts and sub-sub-sub-trusts. The ultimate investor in securities may have no direct relationship with the issuer, but only indirectly through a series of intermediaries. From a common lawyer's perspective, this structure employs a series of trusts. The investor has a right to the right held by his agent. The agent's right is a right to the right of the next person in the chain. If one intermediary were to go into bankruptcy the chain would remain unbroken. Indeed, even if all of the intermediaries between ultimate investor and issuer were to go into bankruptcy, the chain would not break. From a private international law perspective it would be inappropriate to determine the investor's rights by looking to the law governing the ultimate securities. The structure adopted does not purport to give the investor any direct right to the securities themselves. Rather, each link in the chain should be governed by its governing law.

An example of the failure to think in a conceptually sophisticated way is provided by the European Commission's proposals to replace the Rome Convention with a new Community Regulation.[14] The relevant provisions on assignment provide:

Art. 13 Voluntary assignment and contractual subrogation

1. The mutual obligation of assignor and assignee under a voluntary assignment or contractual subrogation of a right against another person shall be governed by the law which under this Regulation applies to the contract between assignor and assignee.

2. The law governing the original contract shall determine the effectiveness of contractual limitations on assignment as between the assignor and the debtor, the relationship between the assignee and the debtor, the conditions under which the assignment can be invoked against the debtor and whether the debtor's obligations have been discharged.

3. The question whether the assignment or subrogation may be relied on against third parties shall be governed by the law of the country in which the assignor or the author of the subrogation has his habitual residence at the applicable time.

The proposed Articles 13(1) and (2) are unobjectionable, indeed banal. They are materially the same as the current provisions of the Rome Convention[15] and follow as a matter of logic from the simple proposition that the relevant governing law(s) regulate(s) the rights created by the respective contracts.

14 Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), Com (2002) 650 Final. The United Kingdom has sensibly chosen not to opt in to the proposed Regulation.

15 The term "assignability" has been removed from the issues determined by Article 13(2).

Article 13(3) is new. In broad terms, although the wording of Article 13(3) is obscure, it seeks to set out a conflict rule for determining who owns a debt, which is treated as separate from the issue of to whom a debt is owed, which is already determined by Article 13(2). It broadly conforms with the rule recommended by the UNCITRAL convention on the international assignment of receivables, but the UNCITRAL rule is subject to a number of exceptions which the Rome I proposal has not adopted. Unfortunately, the separation of these issues cannot be satisfactorily achieved in the manner contemplated. The right to a debt cannot be vindicated in any way other than the bringing of a claim. The party who is owed a debt must, definitionally, own the debt. Three problems may be identified with Article 13(3).

First, what is the position where the laws applicable under Article 13(2) and 13(3) are different? If there are two (or more) assignments of the same debt, what is the position where the first is effective under Article 13(3), but ineffective under Article 13(2)? Clearly the debtor can, and must, pay the party who is identified as owed the debt under Article 13(2). Who is entitled to the proceeds? The party paid or the party identified as the owner by Article 13(3)? By what mechanism would the party identified as owning the debt under Article 13(3) be entitled to claim the proceeds? Would there be a claim in unjust enrichment over against the payee? What law governs such a claim? Is the claim proprietary or merely personal?

This problem does not arise if we treat an assignment which, although ineffective to transfer the underlying right, as creating a right to that right. Such a right is traceable into the proceeds once paid.

Second, by determining the proprietary validity, as opposed to priority, of the assignment according to the law applicable to the assignor's residence the proposal cuts back the availability of securitisation. Adopting the English approach it currently does not matter whether the law of the habitual residence of the originating company allows the creation of trusts or rights to rights. The parties are free to choose to have the sale to the Special Purpose Vehicle governed by English law, or indeed any other law which allows the creation of such rights.

Third, the application of Article 13(3) to successive assignments of the same receivable is obscure. If a debt governed by German law is assigned more than once by a creditor with a habitual residence in France, to assignees with habitual residences in the UK and Netherlands, who then also assign and so on, who owns the debt? Each habitual residence would have to be looked to in turn, with consequent complexity.

Insofar as Article 13(3) is intended to operate as a rule determining the *priority* afforded multiple assignments of the same right, whether by way of security or otherwise, it is unobjectionable provided that "habitual residence" is given precisely the same meaning as the debtor's main centre of interests contained in the Council Regulation on Insolvency Proceedings. However, it is difficult to

understand what a priority rule is doing contained in a Regulation concerned with the law applicable to contract rights. Further, such a priority rule, although as discussed below sensible, should be applied across the board to all assets of the debtor, not just receivables.

b) Tangibles Immovable and Movable

English courts have long declined to decide questions of title to foreign land.[16] Courts of equity have never recognized such a restriction on their competence, as they do not purport to determine the title to things situated anywhere, but merely confer rights against other rightholders.[17]

Under what is now the Brussels Regulation,[18] the European Court of Justice perceptively adopted the same approach in its interpretation of what is now Article 22(1), which confers exclusive jurisdiction in proceedings which have as their object rights *in rem* in immovable property upon the courts of the Member State in which the property is situated. Exchange control restrictions caused George Webb to purchase a house in the Antibes in the name of his son Lawrence. Father and son fell out, and the father commenced proceedings in England for a declaration that the flat was held for him on resulting trust. The European Court of Justice held that the father's claim did not fall within the scope of Article 22(1), so that exclusive jurisdiction was not conferred upon the French courts.[19] This is correct. The trust does not to purport to create any right to the land itself, merely an (English) right to the son's (French) right to the land.

For choice of law purposes, the question of whether an agreement to mortgage land has successfully transferred the right to the land must be governed by the *lex situs*, no such restriction should or does apply to an equitable charge over land.[20]

For movables, the case for the application of the *lex situs* to disputes over the right to the goods themselves is not compelling although all legal systems seem to adopt it. It is commonly said that the courts of the *situs* have control over the asset, but such a justification does not justify the current law which looks to the *situs* at the moment of the relevant transaction, rather than the *situs* of the goods at the time of judgment.[21] The rule has the virtue of certainty, but certainty is a

16 *British South Africa Co v Companhia de Mozambique* [1893] AC 602.
17 *Penn v Lord Baltimore* (1750) 1 Ves Sen 444.
18 Council Regulation 44/2001 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters [2001] OJ L12/1.
19 Case C-294/92 *Webb v Webb* [1994] ECR I-1717.
20 *British South Africa Co v De Beers Consolodated Mines Ltd* [1910] 2 Ch 502.
21 Eg *Winkworth v Christie Manson & Woods Ltd* [1980] Ch 496.

second order principle of justice. Always applying English law would be even more certain but it would not be considered just. It may be that the expectations of the parties are that the law of the place where the goods are situated will govern the transfer of the rights in the goods, but there is an element of circularity in this justification as the parties' expectations will be shaped by the legal rule. As every student of the conflict of laws learns, where a single transaction covers goods in a number of different jurisdictions, or where the transaction concerns goods in transit from one jurisdiction to another, or where there is a succession of transactions concerning goods whose *situs* has changed in the interim, intractable problems are created.

Whatever the justification for applying the *lex situs* to determine disputes as to title to goods, there is no justification for its application to the question of whether rights to such rights have been validly created. This should be determined, in the first instance, by the law as chosen by the parties to the transaction. Charges over assets wherever situated are valid, regardless of the *lex rei sitae*.

The great advantage of permitting the creation of rights to other rights is that it allows commercial parties freedom of choice.[22] If a global security is created over the entirety of a company's undertaking, the parties are not required to take account of the diverse laws to which the underlying rights are subject in order to determine the validity of what has been done.

III. Reform?

If we are to attempt reform of security at a European level, two options present themselves: harmonization of substantive law, and harmonization of private international law rules.

Harmonization of substantive law faces a number of hurdles, not least the Community's lack of political competence to carry out such a project. The most significant practical barrier however is that the problem is not one capable of being addressed at a Community level at all. Only small and medium sized businesses have all of their assets situated within the Member States. For them, cross border security is not a problem. For those businesses large enough for the problem to arise, few will do business only within the Community. Seeing the problem as specifically European is to be unacceptably parochial in outlook.

Harmonization of private international law is of most benefit if it increases the parties' ability to choose for themselves the law governing their transaction, so that they can choose valid and effective forms of transaction. Harmonization so that it can be predicted in advance that the applicable law will not recognize or

22 Eg *Re Harvard Securities Ltd* [1997] 2 BCLC 369 (Neuberger J); cf *Lightning v Lightning Electrical Contractors Ltd* Unreported, April 23, 1998, CA.

will invalidate certain transactions, however commercially useful such transactions may be, is of much less assistance. It is here that that the concept of permitting the creation of rights to rights is beneficial. In determining the *validity* of a security right, particularly a global security over assets of different kinds situated in different jurisdictions, it is highly inconvenient to have the validity of such security determined by the law(s) applicable to the underlying assets. If the creation of the security involves the *transfer* of the underlying rights to the lender, as would be the case in an English mortgage, the conclusion that the law governing the rights secured should determine the validity of its creation is irresistible. The inconvenience of such a position is such that parties should be free to choose a system which permits the creation of security without requiring the transfer of the underlying rights provided by way of security.

Clearly, however, the *priority* either to part or the whole of an estate cannot be determined by the law chosen by the parties to individual transaction. Where a debtor goes into bankruptcy, it is impossible to have the priority of each claim on the fund determined by the law applicable to each individual contract. With many different applicable laws, priority needs a fixed point of reference. It is submitted that rather than look to the diverse laws applicable to the underlying rights which make up the estate of the bankrupt, priority should be determined by the centre of the bankrupt debtor's main interests as determined by the Council Regulation on Insolvency Proceedings. This conforms with commercial expectations and is usually simple to apply, although it must be confessed that the Regulation's definition of the centre of main interests or COMI, may be politely described as somewhat open-textured.

An application of these principles is to be found in *Re Anchor Line (Henderson Brothers) Ltd.*[23] An English company, owning land and movable property in Scotland, granted a floating charge in favour of a Scottish bank, executing the agreement in Scotland. Under Scottish law at that time this form of security did not exist. The English company went into liquidation, funds representing the Scottish assets subsequently coming into the liquidator's hands. However, that the form of security created was not recognized under the legal system where the physical property was situated was irrelevant to the validity of the charge. Accordingly, the assets recovered were payable to the Scottish bank in accordance with the floating charge.

Today, of course, we have the European Insolvency Regulation. If a company with its centre of main interests in England is wound up in England, having created a floating charge over assets situated in other jurisdictions which do not recognize such a security, how are recoveries to be distributed? It is submitted

23 [1937] 1 Ch 483. See also *Re Courtney, es p Pollard* (1840) 4 Deac 27.

that the position is precisely the same as at the time of *Re Anchor Line*.[24] Today, the assets of the company situated in other Member States are to be remitted to England as the *lex concursus.* Under Article 5(1) of the Regulation the opening of the insolvency proceeding shall not affect the rights *in rem* of creditors or third parties situated within the territory of another Member State. However, by giving effect to the priority of the floating charge in the English insolvency proceeding, the *lex concursus* is not cutting back or diminishing the proprietary rights to the assets of third parties in any sense.

If the insolvency proceeding takes place in a jurisdiction which does not recognize the floating charge, a charge over assets situated in a Member State which does recognize such security is not to be prejudiced by the opening of the proceeding.[25] For the purposes of the Insolvency Regulation, such equitable rights are treated as rights *in rem* for the purposes of Article 5(1). A floating charge over assets in the UK or Ireland should not therefore be prejudiced by the opening of proceedings elsewhere.

Of course some legal systems may refuse to accord priority to forms of security (eg the floating charge) which they do not recognize. If a company with its center of main interests in a Member State which does not recognize the priority afforded by rights created by, for example, the floating charge, goes into an insolvency proceeding, and if the *lex rei sitae* of the assets does not recognize the validity of such rights either, the chargeholder will have no priority in relation to such assets.

Borrowers situated in some jurisdictions may therefore, find themselves in the unhappy position of not being able to borrow, or being forced to borrow on disadvantageous terms, because the legal system where they have their main interests is very restrictive in the security rights it recognizes. For such borrowers the lesson is clear: move the centre of your business to another legal system, in the first instance by changing the place of registered office, so that such general security will be recognized in the insolvency proceeding.

What role is left for the law(s) applicable to the underlying rights held on trust or charged? These rights should determine the validity of their transfer, which should include the question of whether transferees of rights take free of the rights to which they are subject. If, for example, a charge is declared over machinery situated in New Zealand, the law of New Zealand should determine whether a purchaser of the machinery acquired his rights free from the charge to which those rights were subject.[26]

24 See also the excellent article by P Smart, *Rights in Rem, Article 5 and the EC Insolvency Regulation: An English Perspective* International Insolvency Law Review 15 (2006) 17.

25 Virgos-Schmit, *Report on the Convention on Insolvency Proceedings* para 104

26 Eg *Macmillan Inc v Bishopsgate Investment Trust Plc (No 3)* [1996] 1 W.L.R. 387.

Whatever view is taken as to the above suggestions, it must be reluctantly concluded that, at present, further harmonization at a European level would be retrograde. This is not to dismiss the efforts of harmonization which have so far occurred. The Brussels Convention (now Regulation), the original Rome I and the Insolvency Regulation were all, in their different ways and whatever their flaws, progressive steps in the right direction. However, that some harmonization is useful does not mean that even more will be better. This is for a number of reasons.

First, the process by which Community instruments are now produced leads almost inevitably to second rate law. Comparing, say, the process by which the Brussels Convention was prepared by experts with a first rate Explanatory Report attached, with the botched political compromise between the Parliament, Council and Commission which is the Rome II Regulation, which will have no Explanatory Report with which we could have tried to make sense of it, evidences the point.

Second, once a Community instrument is in place, any errors it contains will take years, if not decades, to correct as the pace of change is glacial and the reluctance to concede error endemic.

Third, reform at a European level tends to be piecemeal, creating incoherence within national domestic laws. An example of this phenomenon is the Directive on Financial Collateral Arrangements 2002.[27] This Directive sought to pursue the, perfectly sensible, policy objective of facilitating the use of securities and cash as security. Some months prior to this, the UK Enterprise Act 2002 had sought to place further restrictions upon the enforcement of security within the insolvency proceeding of administration in order to facilitate the, perfectly rational, policy goal of facilitating rescue of companies for the collective benefit of all creditors. Both of these policy goals are rational, but they are not readily reconcilable one with another. In order to facilitate the goal pursued by the Directive it was necessary to dis-apply the restrictions on enforcement brought in by the Enterprise Act 2002 when the security was within the scope of the Directive. This is not joined up law making.

Fourth, the gross delays in the hearing of appeals by the European Court of Justice mean that it is currently unacceptable to have yet more commercial disputes brought within the jurisdiction of the court.

Fifth, the Court of Justice in its inflexible interpretation of Community instruments has demonstrated a reluctance to take into account commercial reality that disqualifies it from being a suitable appellate court in commercial

27 Implemented in England by Financial Collateral Arrangements (No 2) Regulations 2003.

disputes.[28] It is difficult to understate the damage which has been done to the Court's reputation in England by the idealistic pursuit of a harmonized community legal sphere at the expense of justice between the parties.

Sixth, it is very unlikely that the conceptual approach set out in this paper will either be adopted or understood if reform is undertaken at a European level. Common lawyers themselves also sometimes fail to appreciate the conceptual distinctiveness of equitable rights.[29] Indeed, the significance of the difference between a mortgage and a charge for the purpose of choice of law rules is not always appreciated in England.[30] From a private international law perspective, one of the reasons for this is the need to "pigeonhole" issues for the purposes of characterization. Common law courts adopt a "broad internationalist spirit"[31] in this process, using conceptual categories which are found generally. For example, for the purposes of private international law, the courts distinguish between movables and immovables, although this distinction is not found at a domestic level, rather than the division between realty and personality, which is specific to the common law. This approach can cause equitable rights to other rights, which do not fit into the categories recognized by Gaius or Justinian, to be lost in the dark.

Here we are, to an extent, the prisoners of history. There is a widespread and unfounded view that common law concepts, such as the trust or charge, are wedded to the legal systems from which they spring and cannot be imported into legal systems with a different history. Part of the purpose of this paper has been to try to show how a conceptual account of such rights can be given, and how such an idea can be imported into other legal systems without disrupting their underlying structure, just as, centuries before, the courts of equity were able to supplement, without contradiction, pre-existing rights at common law. It is the concept, not the history, which is important. Common lawyers themselves are sometimes guilty of obfuscation, enjoying the special magic of equity, like the followers of a cult, where the mysteries are cloaked in obscure language making it inaccessible to outsiders.

The alternative to the conceptual approach argued for here is to have more and more transaction specific rules, whether in relation to securitization, the holding of intermediated securities or the taking of security over financial instruments. Practical commercial lawyers may be tempted by such an approach, parti-

28 Case C-116/02 *Erich Gasser GmbH v MISAT srl* [2003] E.C.R I-14693, [2005] Q.B. 1; Case C-159/02 *Turner v Grovit* [2004] E.C.R. I-3565, [2005] 1 A.C. 101; *Owusu v Jackson* [2005] E.C.R. I-1383, [2005] Q.B. 801.

29 Eg R Nolan, "Equitable Property" (2006) 122 L.Q.R. 232.

30 Eg H Beale, M Bridge, L Gullifer, E Lomnicka, *The Law of Personal Property Security* (2007), [20.54]

31 *Raiffessen Zentralbank Osterreich AG v Five Star Trading LLC* [2001] CA Civ 68, [2001] 2 W.L.R. 1344 at [27] *per* Mance L.J.

cularly those with a specialist practice in a narrow field, but it is very much a second best option. First, such rules inhibit innovation. Second, their scope is, at the margin, indeterminate as the nature of the transaction is determined by its function. Third, such rules tend to be complex and overlapping, leading to the necessity of obtaining ever more specialist advice. Paradoxically perhaps, the most practical approach to the problem is to tackle it at a more conceptual level.

It cannot be argued that English law is in a state of Panglossian perfection. No doubt some fence mending is necessary. The English system for the registration of security is markedly inferior to that found in other common law countries, notably the United States. However, reforming the law at European level to tackle minor flaws at a national level would be like tackling an in-growing toe-nail by amputation of the leg.

Unfortunately, the English model, however dynamic, flexible, useful and commercially desirable does not reflect the dominant approach at European level. Of course, whether I consider a move towards harmonization at a European level sensible has little bearing on whether it will happen. The fear must be that the verdant common law, in England, is about to be covered in concrete by Regulations of the European Union. However, on this occasion there is cause for hope. The commercial significance of the law I have just described is such, and the lobbying power of the market so great, that even the European Union may hesitate to tamper. Pity the poor Jamaicans, dragged before the courts of a Member State when the dispute to which they were parties had little or nothing to do with the European Union.[32] Nobody is going to lobby for them.

Lawyers tend to think of the law as constantly improving as it is developed and reformed. Unfortunately this is not the case, and the danger is that the law can regress as well as advance.

32 *Owusu v Jackson* [2005] E.C.R. I-1383, [2005] Q.B. 801.

Choosing the Right Approach for European Law Making:

Commentary

by

Ulrich Drobnig*

Table of Contents

I. The issues

The following remarks are less in the nature of a comment to Robert Stevens' preceding paper. In my understanding, the intended meaning of the present topic is not to discuss the need for European lawmaking in the field of proprietary security. At issue here is not the "whether", but the "how" of solving that task. In other words, *which method* should be chosen by a European lawmaker for establishing the necessary rules.

In the limited framework of these Comments, two questions are in my view of primary importance.

First, which fundamental approach in substance should be taken in elaborating European *substantive* rules on security rights in light of the present complex variety of existing national rules and of existing present practices and economic

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demands? And secondly: what should be the relationship between future European rules on proprietary security in movables and the existing national regimes? Both issues so far have attracted remarkably little general attention and discussion; the following remarks therefore are more exploratory and subjective than affirmative.

II. Substantive method

1. A uniform security right as basis

The decisive key-model for dealing with the basic issue of method is in my opinion Uniform Commercial Code art. 9 – which is not uniform at all in the Continental sense but merely a set of model rules adopted by the 50 American states. It was so persuasive that it was later copied by a set of similar provincial Acts in Canada (including the Civil Law province of Quebec) and still later by New Zealand and is presently considered as unified Australian law. However different some of the detailed rules may be, all of these Acts have one feature in common: there is basically only one general security right which may encumber all types of tangible as well as intangible movable property. It covers both possessory as well as non-possessory security; it would cover both the English chattel mortgage as well as the equitable charge; and in a certain sense, it may also be floating.

This unified approach has also been adopted by a truly international model, the UNCITRAL Legal Guide on secured transactions (which is limited to security in movables).

The models of the USA, Canada and Australia are persuasive for Europe also for an external reason: The unitary approach used in each of these federal states was adopted to overcome the internal diversities of law and legislation dealing with the then new phenomenon of non-possessory security. This had led to the enactment in each of the 50 American states of diverging statutes on chattel mortgages, conditional sale (ie reservation of title), accounts receivables, etc. This is exactly the same situation with which almost all European countries are confronted today. The slow, but for well-known economic reasons inevitable growing demand for non-possessory security rights has been solved in most countries by piece-meal, special legislation. In France, a good dozen of special statutes for very narrow fields were enacted in the course of the 20th century, from enterprise mortgage (1909), a fictive possessory pledge for the purchase price of automobiles (1934) to non-possessory pledge of inventory (2006). This is an issue which calls as much for national reforms as it opens the way for an overarching transnational European solution.

2. Privileged status of security for purchase money

There is, however, one internal limit to the basic idea of a uniform security right, and that is the treatment of non-possessory security securing credit for purchase money.

UCC art. 9 and its followers in Anglophonic countries have formally integrated security for purchase-money into the general scheme of security interests. This requires, however, a somewhat artificial operation: Since it is in general the debtor who grants security interests in its assets, in the case of a purchase the buyer is regarded as enabled to agree with the seller (or other creditor) to create a security interest in the bought goods, although the contract of sale due to non-payment of the purchase price has not yet been performed. This purchase-money security is awarded a special priority over other security interests, provided certain additional requirements are complied with.

Basically, it is only required that the purchase-money security interest must be registered within 20 days after the buyer has received possession of the goods.[1] If the buyer has bought goods that are inventory, registration must take place when the purchaser receives possession of the bought goods.[2] Additional, more demanding requirements must be met if at the time of registration an earlier conflicting security interest in inventory had already been registered. In this case, the new secured creditor must notify the holder of the preceding security that it intends to create or has created a purchase-money security interest in specified parts of the inventory.[3] It should be added that in spite of registration of the seller's security right the latter is lost if a buyer in the ordinary course of business acquires the goods, and this is so even if the buyer knows that the original seller has a security interest.[4]

Broadly speaking, a very similar result can be achieved in Europe, although by a very different and simpler route. The legal device generally used in most European countries to achieve the same result is the retention of title (or ownership) in the sold goods. The seller agrees with a buyer whom he grants time for payment of the purchase price, that title is not to pass until the remaining purchase price will have been paid. For present purposes, I restrict myself to this basic model of the simple retention of title; the various forms of extending either the scope of the security or that of the secured claim need not be considered in the present context. As under UCC art. 9, the seller's security enjoys priority. How-

1 UCC § 9-324(a).
2 UCC § 9-324(b)(1).
3 UCC § 9-324(c) and (b)(2)–(4).
4 UCC § 9-320(a).

ever, this priority does not require special formal steps, especially no registration.[5] Priority results from the fact that the seller retains title; it remains the owner of the sold goods until payment of the unpaid portion of the purchase price.

An additional, very important aspect of the European approach is the effect of retention of title in executions by the buyer's creditors and in the buyer's insolvency proceedings. The seller's title ensures immunity against the claims of the buyer's creditors in these proceedings.

The preceding considerations speak in favour of the European approach of relying upon title retention as a technique for securing the seller's credit for purchase money. In this respect, then, a departure from the general, unified approach to security rights is justified and necessary. However, it should be emphasized that the departure is not absolute. It affects mainly creation and enforcement as well as the effects against third persons and priority of the purchase money security; in other respects, the ordinary rules on security rights are applicable.[6]

III. Co-existence of a future European and existing national regimes?

At present, there is little realistic chance that a future European regime of security in movable assets may replace – whether only for border-crossing security rights or even completely – the existing national regimes. The issue as formulated in the preceding title therefore rests on the assumption that the most that may be achieved in the foreseeable future is a co-existence of the national regimes and a unified European regime. How could such a co-existence look like?

Understandably, since even the factual assumptions of this issue still lie in a distant, uncertain future, this specific issue also has rarely attracted attention so far. Since I am aware of only one foreign comment, I must mostly rely on a very few German voices.

1. Precedents for a 28th "European" legal regime

So far, no full branch of European civil law has been unified or harmonised on the European level. Not only are there understandable doubts whether there is a tenable jurisdictional basis for legislative action in this field. But so far, also the political will for action on the European level is missing.

5 Although a few European countries require such registration (*cf.* Spanish Law on instalment sales of 1998 art. 16 par. 5) or allow it (*cf.* French CommC art. L 624-10, inserted in 2005).

6 Generally in this sense also E-M Kieninger, *Security Rights in Movable Property in European Private Law*, 2004, 669.

As a substitute, it has been occasionally considered whether there may be an alternative for European legal harmonisation or unification of the 27 national legal orders. An important alternative may be the elaboration of an *additional* 28th European legal regime which might apply especially to border-crossing transactions between companies and residents of two or more member states, but perhaps even without this limitation. Two such projects have been envisaged for specific sectors and one has already been realized in another sector.

a) The common frame of reference for a European contract law

The first proposal for a 28th European legal regime has been evolved by the EC-Commission in a series of communications issued in the period between 2001 and 2004. Initially, several alternatives – including non-action – were presented to the interested public who was invited to respond and did respond. One of these alternatives was to evolve, on the basis of academic work that earlier had been effectuated on the European level, a frame of reference for contract law to be used on a European level, especially for border-crossing contractual transactions.[7] The alternative between an opt-out or an opt-in solution was provisionally settled, as was to be expected, in favour of the less stringent form of the opt-in alternative.

Thus, the idea of a 28th, European legal regime was born. Whether that idea will be realised on the political level is not yet clear. However, even if the idea should fail to be adopted on the political level, that would not necessarily be fatal.

Neither a legal nor a political sanction is necessary for the creation and effect of a European law of contract. Since the parties enjoy, in principle, freedom of contract, they are free to choose any kind of frame of reference for their contracts, whether or not sanctioned by legislation. Of course, it goes without saying that a frame of reference based upon the Principles of European Contract Law (PECL) or on the UNIDROIT Principles of International Commercial Contracts[8] commands a higher reputation than a private set of conditions and therefore is more likely to be adopted by parties.

It is obvious that a more or less complete system of contract law based upon an optional instrument, since standing on its own "feet", would qualify as a 28th, "European" regime of contract law.

7 *Cf*. E McKendrick, 'Harmonisation of European Contract Law: The State We are In': in S Vogenauer and S Weatherill (eds), *The Harmonisation of European Contract Law: Implications for European Private Laws, Businesses and Legal Practice*, 2006, 11–13. Cf also S Vogenauer and S Weatherill, 'The European Community's Competence to Pursue the Harmonisation of Contract Law – an Empirical Contribution to the Debate', in S Vogenauer and S Weatherill (eds) 108–112; and D Staudenmayer, 'European Contract Law – What Does It Mean and What Does It Not Mean?', in S Vogenauer and S Weatherill (eds) 235–241.

8 MJ Bonell, *An International Restatement of Contract Law* (3d ed 2005).

b) European private law organisations

One field in which European regimes have been established that exist side by side with the national regimes is company law. Three European institutions may briefly be mentioned: the European Economic Interest Group of 1985; the European Company, a European form of a share company of 2001; and the European Cooperative of 2003.

However, none of the three types is exclusively governed by European-"autonomous" law. For many detailed aspects the European rules refer to the law of the "seat" of the regulated institution.[9]

The preceding short description makes clear that the existing European institutions of private law organisations, while primarily resting on European rules, in addition also refer to the corresponding variety of relevant national provisions.

c) Proposed rules for a "Eurohypothec"

Of greater direct relevance, because dealing with an institution of property law and, more particularly, one of proprietary security, are the proposals for a "Eurohypothec" (or Euromortgage). Elaborated on a supranational level by institutions dealing with various forms of real property security, the drafting of proposed rules achieved a progressed degree of maturity in 2005.[10]

Some rules expressly refer the solution of various issues to the law of the encumbered real estate. One of the three guiding Principles declares that the Eurohypothec is subject to the law of the location of the property (*lex rei sitae*). This applies in particular to determining the competent land register, the possibility of issuing a mortgage certificate and to the relevant security agreement.[11] The same is true for determining the limits of the encumbered land, the extension to buildings that legally may not be part of the encumbered land and the possibility of encumbering another mortgage or land charge or a Eurohypothec as well as to the coverage of fruits, profits and proceeds of insurance against property damage (cl 3.5).

9 Typical for the combination of European uniform rules and the diverging national applicable national rules is the Regulation on the European Company (*Societas Europea*). While the original draft in an attempt to offer a complete regulation contained some 400 provisions, the text of the Regulation of 2001 comprises only 70 articles. Article 9 par 1 refers all unregulated issues to the law of the seat. A similar technique had already been employed before (cf. Regulation on the European Economic Interest Group of 1985 art 2 par 1) and has been employed afterwards (Regulation on the European Cooperative of 2003 art 8 par 1). Details in M Habersack, *Europäisches Gesellschaftsrecht* (2006).

10 A Drewicz-Tulodziecka (ed), *Basic Guidelines for a Eurohypothec*, 2005, 11–22.

11 Clauses 2.3; repeated for the two last issues in cl. 3.3.

The transfer of a certificated Eurohypothec is also subject to the law of the encumbered land (cl 5.2). The same is true for the formal declarations of the parties (cl 5.3). Whether, in case of an acquisition from a person who is not entitled to dispose, the acquiring person is in good faith is also governed by the law of location of the encumbered land (cl 5.4).

The priority of encumbrances is governed by the law of the encumbered land, and may depend either on the time of registration or on the time at which the application for registration was submitted; in the latter case, national law must provide that the applications for registration is to be transferred to the register in the sequence in which they were submitted. For a Eurohypothec exceptions from the preceding rules are only admitted for those unregistered statutory charges which are of limited duration and are calculable (cl 7.2).

Enforcement of a Eurohypothec is subject to the law of the enforcing court (cl 8.6). The rules stipulate a maximum time limit of 12 months after filing of the application (cl 8.1). Enforcement must be effected by means of either a court proceeding; if another procedure is admitted, the parties must be entitled to call on a court (cl 8.3).

In contrast to the long preceding catalogue of issues which are submitted to the law of the encumbered real estate, only rather few provisions apply independently from the *lex rei sitae* or have a specifically European purpose. The most important deviations from the law governing the real estate are the following: The Eurohypothec is explicitly defined as a non-accessory land charge (cl 2.1). This general rule is further specified by another provision according to which the creation, transfer and existence of a Eurohypothec as well as the exercise of rights deriving from it, is independent from the existence of a secured obligation (cl 3.4). Accordingly, the mortgage will neither extinguish upon repayment of the secured obligation (cl 6.1), nor will a transfer of the secured claim effect the transfer of a Eurohypothec (cl 5.5).

Some rules contribute specifically to the European mission of the Eurohypothec: Eg, one claim may be secured by several Eurohypothecs, encumbering real estates in several member states (cl 3.5). The secured claims may have a border-crossing character (cl 4.1) and the currency of the secured claim may be expressed in the currency of any member state of the European Union (cl 3.4).

2. Conclusions for European rules on security in movables

It goes without saying that none of the three precedents which have been sketched in rough outline in preceding section 1 can be used as a directly applicable model. Nevertheless, they furnish some material which may be used as a source of inspiration, both in a positive and in a negative sense.

The first lesson we learn is that, however complete the immediately applicable rules are framed, it is unavoidable that the fringe areas cannot be regulated in detail. This is true, in particular, for execution and insolvency proceedings. An autonomous European regime may and must deal with core issues, especially priority; but the details of implementation must unavoidably be left to the applicable national rules. And these excluded areas will of course impact upon both procedures and results. Therefore the attempt to prescribe the maximum length of an enforcement proceeding[12] is heroic but has little chance of success.

One of the major reasons for the draft on the Eurohypothec to rely so strongly on the law of location of the encumbered real estate[13] is obviously the existence in all member states of land registers – however different the details and effects of registration may be. There is no comparable convergence for registration of proprietary security in movables, quite to the contrary. While some states demand registration for virtually all types of security in movables, other countries use a selective approach and still others do not provide for any registration. The rules envisage a relatively close system of registration since this appears to be the only means to achieve publicity on a broad, border-crossing internal market. The envisaged registry system will be a European register on an electronic basis. Consequently, it need not consider existing national systems and the corresponding legal consequences. On the other hand, the implementation of a registry will require a certain financial investment which may hamper and delay the establishment of the Eurohypothec. However, recent practical experiences with comparable problems show that this difficulty can be resolved.

Whether or not retentions of title should be subject to registration is controversial. So far, most member states do not require registration, but a few insist on or at least allow it. In view of the basic decision for demanding registration it is difficult to justify a complete exclusion.[14] The draft rules propose a compromise: Registration will be the general rule but will retentions of title in inventory will be exempted since the security rights in these assets are usually short-lived as inventory generally is quickly sold. In the case of an extended retention of title, the proceeds, however, are subject to registration.

In the light of the preceding, necessarily brief and provisional considerations, a positive reply to the issue discussed here can be given: It appears to be feasible to install a 28th European regime for security in movable assets.

12 Supra 1 c in fine.
13 *Supra* 1 c in the beginning.
14 Impliedly for this, however, EM Kieninger, *supra* n 6, 664 for the simple retention of title.