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The Financing of Small Businesses: A Functional Analysis of Three Legal Models

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A FUNCTIONAL ANALYSIS OF THREE LEGAL MODELS

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I. Introduction

In many states, small businesses are the engines of the economy. In those states, small businesses create the bulk of new jobs, not only through their start-up, but also through their continuous growth. The rate of their growth, if they are successful, is significantly higher than the rate of growth of larger business enterprises.

In other nations, small businesses do not contribute a similar amount, either to the gross domestic product or to job growth and creation. In those states, although large numbers of small businesses are created, they usually are limited in size to two to four employees. When they get to that size, they seem to stop growing. In large part, this is a financing problem. A small business can grow to two or four employees based on family savings but further growth in size and employment often requires financing from outside the family – i.e., financing from a commercial lender.

If the small business owner also owns land, he can raise such financing by placing a mortgage (hypotec) on the land. But, the land-owning aristocracy is not usually a hotbed of entrepreneurial drives and skill. What can entrepreneurs in the rest of the population do to raise the necessary financing? In too many cases, commercial lenders will not grant "signature loans" to the landless, and those borrowers are forced to turn to the illegal loan market ("loan sharks"). Fees or interest rates from such lenders are too high to permit slow and steady growth, and such interest rates increase the likelihood of business failure.

What can be done to induce commercial lenders to provide small businesses with the financing they need? In many systems, the answer is to provide such lenders with collateral which is not land. Although the drafters of the Napoleonic Code considered moveables and intangibles to be "lesser assets," and therefore not a source for significant financing, the world has changed enormously since that determination was made. Banks in the Midwest in the U.S. find that cattle make better collateral than farmland. The cattle can be sold in three to seven days for 95% of their market value; while the bank may wait for months to find a suitable buyer for farmland, and the price will depend on the number of potential buyers. World Bank studies show that a nation's capital can be increased by 60% if a commercially effective financing system can be developed which uses movables and intangibles as collateral for loans.

What is needed to provide such a commercially effective secured financing system which uses moveables as collateral? The basic economic definition is that the collateral must have sufficient economic value to a potential secured creditor to induce that creditor either (1) to give credit at a preferential rate for fees or interest or; (2) to make more credit available than the creditor would have granted if the loan was unsecured. In many legal regimes, creditors take security on all loans, but consider the collateral to have no actual economic value. In such loans, the fee structure or interest rate is the same as it would have been for unsecured credit, instead of being lower; and the amount available is also the same, so there is no benefit to the debtor from its grant of the collateral.

Thus, the conduct sought by society from a potential secured creditor is not merely that it receives a benefit by taking an interest in the collateral. Instead, the conduct sought by society is that a potential secured creditor gives benefits to the debtor in return for obtaining its interest in the collateral.

Whether the system created is effective or ineffective will depend upon whether creditors perceive that secured loans involve significantly less risk that the loan funds will be lost. That perception, in turn, depends upon whether the creditor determines that it will receive adequate protection from the collateral, or from the proceeds of the sale of the collateral, if the debtor cannot make the payments after appraising the market value of the collateral. The creditor makes this determination by: 1) determining the cost of obtaining protection; 2) determining the cost of enforcing his interest; 3) determining how much of that value will be obtained by sale of the collateral after default; and 4) determining whether and how much of that value will be paid to the secured creditor – i.e., whether any other creditors can assert claims which will have priority to the collateral or its proceeds. If the creditor believes that only 10% of the appraised value of the collateral will be paid to it through the sale process, it will require the debtor to put up collateral worth ten times the amount of the loan before considering the collateral to have any value to it. Only then will the creditor determine that the collateral gives enough protection from risk of non-payment to reduce the interest rate charged. And finally, 5) the potential secured creditor will want to know, before it makes the loan, whether its interests are protected from, and take priority over, the claims of the third parties both before and after any default by the debtor.

There are basically three legal regimes which furnish models of laws designed to promote the use of moveables and intangibles to finance small businesses. One is the "nantissement de fonds de commerce," a device used in the French law which creates a mortgage on a business – or at least some parts of it. The second is the "registered charge" of the European Bank's "Model Law on Secured transactions," which is modeled in large part on the English financing device called a "floating charge." The third is the North American "security interest" used in Article 9 of the Uniform Commercial Code in the U.S., and in the Personal Property Security Acts in Canada.

II. The Financing Needs of a Small Business

What moveable and intangible assets does a small business have which can be used to provide collateral? More importantly, what assets could a small business obtain on credit, if financing were available, which it cannot afford to acquire for cash? Small businesses have a range of assets, which include equipment, inventory, accounts and intellectual property (trademark, copy rights, and sometimes patents). The small business may also have real estate. If so, it may be able to raise sufficient financing through a real estate mortgage.

If equipment can be purchased on credit, the small business can modernize more quickly than if it must wait to purchase for cash. If the equipment can be purchased on secured credit, World Bank studies show that the financing will be more easily available and the cost to the small business will be significantly lower than for unsecured financing. If secured financing is available only from the seller of the equipment, however, the seller's monopoly position as a secured financing will erode much of the savings to equipment purchaser. Thus, it is important that equipment financing be available from both equipment sellers and from other, more general, commercial lenders.

The same analysis applies to purchases of inventory. Again, it is important that inventory financing be available from both the providers of the inventory (trade creditors) and from lenders.

Small businesses often find that their sales increase markedly if they sell to their customers on credit. Sometimes, they go through the formalities of selling using a security device, such as retaining title until they are paid. However, more often, they sell more simply on "open account" believing that they know their customers well enough to guarantee payment. In either case, there is a limiting principle on how much selling on credit they can do, because the proceeds of the sale are needed to replenish the inventory sold. Unless the small business has a reservoir of cash, replenishment of inventory can be done only when the business has realized cash from the sale of prior inventory. Thus, the ability of a small business to sell on credit of any kind is dependent upon its ability to raise money on the accounts generated by cash sales. The amount of cash generated by a sale or financing of accounts will depend upon whether the buyer or financer of the accounts believes that its interests will be securely protected against the account debtor and third parties.

III. Nantissement de Fonds de Commerce

French Law permits creditors to have mortgages (hypotec) on immoveables (real estate), but not on most moveables (chattels). It does allow mortgages on cars, airplanes and ships on the basis that they are individually identifiable, because each has an identification number. In addition, French law permits a creditor to have a mortgage on an entire business – or at least on some parts of it – a nantissement de fonds de commerce. This mortgage covers the equipment and intellectual property rights of the business, but not its inventory or accounts. It is registered in the Commercial Registries where the business, and any of its branches, are located. Even though the debtor is in possession, the registration is sufficient publicity to give the first creditor priority over subsequent mortgage creditors.

However, there are several limitations on the mortgage creditors' rights. His rights are subordinate to perfected equipments liens, if the holder of the equipment hereon notified the mortgage creditor, and to wage and tax claims. It may also be subordinate to a seller's claims arising out of retention of title clause, and no notice of such clauses is required. Further, the debtor may sell the equipment assets of the business, and a good faith purchaser will not be subject to the mortgage. Finally, enforcement may only be through a sale of the assets by judicial auction. The creditor may not take over the business or its assets, or attempt to sell them through normal commercial channels.

How well does this mortgage of a business stand up under the five-part functional analysis suggested above?

1) It does not cost a lot to create the nantissement de fonds de commerce, but it is very costly to create a non-possessory security interest which covers all of the assets of a small business. The commercial usefulness of financing devices is usually measured by three subsidiary concepts: Can the collateral be described generally? Will the financing device cover after-acquired property? And, will it apply to future advances?

The Nantissement covers all equipment and intellectual property rights, without having to describe each piece of equipment or right. It also covers new equipment added to the business by the debtor – unless the new equipment is covered by an equipment lien (for which there is notice) or, perhaps, by a retention of title clause (for which there is no notice). It also covers future advances, whether made pursuant to a commitment in the opening credit or not.

However, the French model does not allow the debtor to use this device to raise money using its inventory and accounts as collateral. Thus, the amount of secured financing available is limited. To use inventory as collateral, the retention of title device is available, but it is of limited utility. First, it is available only to sellers, not to lenders. Second, the seller's interest is cut off when the inventory is sold, and the seller has no priority interest in the proceeds of the sale. To use accounts as collateral, French law assignment of an existing and identified account. Thus, the accounts cannot be described generally, and accounts which arise after the creation of the credit agreement are not automatically covered, raising the costs of creating a security interest on this class of collateral.

2) Enforcement of the mortgage on a business is available if the debtor defaults on its obligations. Such enforcement begins when the creditor initiates foreclosure proceedings in court, which can begin – eight days after the creditor has given the debtor notice of an accretion of default. The court must make a determination of default and order the sale of the business through a judicial auction. There are many possibilities for litigation during this process. The debtor or third parties can dispute the sufficiency and timeliness of the notice, whether there was a default, the validity and enforceability of the mortgage, whether it was properly registered. These may increase the cost of enforcement of the mortgage.

3) What value will the creditor receive from the enforcement of this mortgage on a business? There is always some uncertainty about valuing collateral. The collateral may be difficult to appraise because it has a limited market or depreciates over time, or is subject to fashion or technological obsolescence. At the time the loan is made, it may be difficult to determine the amount of value that will be obtained at a later sale after default, because a) market conditions can change, b) the mercantile expertise of the people running the sale may be limited, and c) the results of "distress sales" are somewhat unpredictable.

Under French law, the business is sold through a judicial auction, because court officers are the only persons allowed to sell property free and clear of prior encumbrances. However, sales by court officers are recognized as "distress sales" and bring distress sale prices. Normal commercial processes are not available, and thus the value obtained is not likely to be a normal commercial value. Nor is the creditor allowed to simply take possession of the business, even under a court order. Since the mortgage does not cover all the assets of the business, it is difficult to have a judicial sale of the business as a going concern. Thus the value that the creditor will receive is not likely to be the "going concern" value of the business, but will be the distress sale value of some of its disaggregated assets – not very much.

4) Will the secured party be protected against the claims of third parties, including other creditors' bankruptcy official purchasers and statutory claimants? If the creditor has registered its mortgage on the business in the proper Commercial Registry,

he will be protected against unsecured creditors and other creditors with such mortgages that register them later. The creditor will also be protected from bankruptcy officials, but will be subject to super – priority claims, such as some wage claims and to tax claims having a special statutory priority. The creditor will not be protected in many sales and purchases of equipment, however. The debtor can sell assets, such as equipment, and the mortgage creditor will have no claim to either the assets sold or to their proceeds. Further, when replacement equipment is purchased, it may be subject to either an equipment lien or to retention of title clause. A registered mortgage creditor's claim is subject to a registered equipment lien, as long as notice e is given, and may also be subject to a title retention clause claim, for which neither registration nor notice is required.

5) Can a prospective creditor determine, with certainty and little cost, before the loan is made, whether any other creditor will have a better claim to the collateral? By checking the Commercial Registry, the prospective creditor can determine whether there are other creditors with a mortgage on the business who have registered before him and therefore have a better priority. If there is one, he will stand first in line among that class of creditors. However, the prospective creditor's position and claims can be affected by subsequent actions of the debtor in buying and selling assets, especially equipment. The prospective creditor can lose its entire interest through sale of the existing equipment, and it can have a subordinated interest in the newly – purchased equipment which replaces it. Such actions can be made into events of default by negative pledge clauses, but the creditor will still not have any priority interest in either the new equipment or the proceeds of the old equipment. Finally, wage and tax claims are unpredictable. Thus, the prospective creditor cannot be certain of its position in the future with respect to the assets being offered by the prospective debtor.

IV. The EBRD Model Law on Secured Transactions

The World Bank studies which detailed the positive effect of secured financing on a state's economic activity induced the European Bank for Reconstruction and Development (EBRD, or European Bank) to develop and publish a Model Law on Secured Transactions. The EBRD has also carried on an active campaign to obtain enactment of this Model Law in Central and Eastern European countries. The provisions of the Model Law create a "registered charge", and many of its underlying concepts are similar to those of the English "floating charge", which allows secured financing of corporations.

Unlike the French mortgage on a business, the EBRD registered charge can be sued to cover all of the important assets of a small business – its equipment, inventory, accounts and intellectual property rights. In addition, each of these types of assets may be used separately or in the aggregate to support financing from many different lenders or from a single lender. Registration of a "charge" on an asset or type of asset will give a prospective creditor priority over any lender who makes a later registration of a charge on the same assets. However, the Model Law gives extensive protection to "trade creditors" who sell goods on credit to the debtor, and they may be able to defeat the interest of an existing registered charge.

How well does the EBRD registered charge stand up under the five – part functional analysis set forth in Part I of this paper?

1) It does not cost a lot to create an enforceable registered charge. The Model Law allows collateral to be described generally, to include after-acquired property, and to apply to future advances. It requires the registration of a "registration statement" which may be a different document than the credit agreement between the parties (the "charging instrument"). This is an important feature, allowing the parties to give public notice of the existence of their secured transaction and identify the parties, the collateral, and the secured debt. The collateral may be described either generally or specifically. If generally described, it can include after-acquire property conforming to the general description. The secured debt may also be described either generally or specifically and this allows a generally described debt to include future advances up to a stipulated maximum amount.

The registration system is only outlined in the Model Law. A lender needs to obtain from the debtor a signed charging instrument and a signed registration statement. Each document is simple, and registration is straightforward. The registrar may reject a registration statement if it "does not comply with the requirements of the" the Model Law and those requirements have been kept simple. They basically require only the "identification" of the parties to the transaction, the secured debt and the charged property. However, there may be a problem relating to registration fees. Stamp taxes can exceed 2%, and are commonly levied on all registrations of "floating charges" in England. This can be a significant cost barrier which inhibits the use of secured financing. The Model Law does not require that registration fees because limited to the actual cost of registration, rather than being regarded as a revenue source.

2) Does it cost a lot to enforce a security interest? After a default, the secured creditor must first deliver an "enforcement notice" to the debtor, and then register that enforcement notice within seven days. The deliver and registration of the enforcement notice entitles the secured creditor both to take "protective measure" and to "realize the charge." "Protective measures" include taking possession of the charged property, using a "[bailiff]" to take possession, immobilizing it, or any "measures as agreed with the chargor." This structure provides many possibilities for litigation, and the delay and uncertainty created by litigation. The debtor or third parties can seek court intervention to declare the enforcement notice invalid, resole disputes between debtor and creditor over the creation, validity and enforceability of the charge, resolve priority disputes between secured creditors, determine whether improper protection measures were taken, order "appropriate" protection measures, and invalidate clauses in the charging instrument.

To summarize, the Model Law takes many steps to reduce enforcement costs. After a default, the secured creditor delivers an enforcement notice to the debtor, then registers it. The creditor is then permitted to take possession voluntarily or to immobilize the collateral. If the debtor resists, the secured creditor can obtain the assistance of a "[bailiff]" without first obtaining a court order. The debtor does have many opportunities to litigate several aspects of this process. The secured creditor may obtain further enforcement devices by stipulating them in the contract.

3) Does enforcement of the security interest provide real commercial value for the creditor? Under the Model Law, the secured creditor controls the manner of the sale of the collateral, but is required to realize a "fair price." This will probably lead to realization of greater value than under the French system, where court enforcement

officers usually are the only persons allowed to sell property free and clear of prior encumbrances. This provision of the Model Law will permit use of the private sector to seek prices closer to market value. The sales by court officers are recognized as "distress sales" and bring distress sale prices. Under the Model Law, normal commercial processes will be available, and can bring normal commercial (albeit wholesale) prices.

However, it is not until sixty days after delivery of the enforcement notice, that the secured creditor may sell the collateral. The effect of the delay if the charged property is fresh produce, fish, trendy clothes, or a volatile stock would be unfortunate for both creditor and debtor. A new bureaucracy called a "proceeds depository" is created to disburse the sale proceeds. A buyer of the repossessed collateral gets good title only if the sale proceeds are paid into the proceeds depository.

Thus, in realizing value, the Model Law is helpful in permitting the secured creditor to control any sale of the collateral, so that it can maximize the value received if it chooses to do so. There are two major restrictions in the Model Law on any such sales. One is that the sale cannot occur until sixty days after the enforcement notice is delivered. The value of the charged property could fall rapidly during that period for a wide variety of reasons. The second is that a bureaucracy called a Proceeds Depository is created, and usually must be sued, and its costs may reduce the value received by the secured creditor.

4) Is the secured creditor protected against claims of third parties, including other creditors, bankruptcy officials, purchasers and statutory claimants? The Model Law provides a concrete set of rules to determine priority among creditors. A secured creditor which registers its charge is protected against subsequent registered secured creditors. The non-possessory registered charge gives public notice of the encumbrance over the collateral. Thus, among registered secured creditors, there is no problem with "secret encumbrances". However, not all charges need to be registered under the EBRD Model Law, and these unregistered charges can have a "super-priority" which will defeat the interests of the registered secured creditor. One such exception is the "unpaid vendor's charge"; another is the possessory charge. (discussed under Question 5)

The unpaid vendor's charge is an unregistered title retention device. Usually it protects creditors who sell goods on credit, but not creditors who lend money. The former offer credit which is "tied" to sales only of their products, and which is usually only short term credit. On the other hand, under an effective secured financing system, the latter can provide long-term financing for all necessary costs of starting an enterprise.

Under the EBRD Model Law, an "unpaid vendor" obtains an unregistered charge which gives that vendor priority over all registered charges. The unpaid vendor gets such priority (a superpriority) whether it registers the charge or not, and whether its charge arises before or after registration of other charges. There is no public disclosure of the existence of the unpaid vendor's charge, so it is a secret encumbrance from the perspective of any potential lender of funds. An unregistered "unpaid vendor's charge" lasts for six months or until the vendor is paid. It can be converted into a registered charge at any time during those six months. A creditor who is an unregistered unpaid vendor has all the enforcement powers of a registered secured creditor.

If collateral is sold, the secured creditor does not automatically have any interest in the sale proceeds. However, the Model Law offers effective protection against purchasers of goods covered by a charge because buyers of collateral will hold the collateral subject to a registered charge, unless they are a buyer of inventory from a merchant. That is the balance struck in most viable secured financing systems.

5) Can potential secured creditors determine, with certainty and at little cost, before the loan is made, whether any other creditor will have a better claim to the collateral? Under the EBRD Model Law, between "registered charges," the first to be registered has priority over all other registered charges, regardless of the actual knowledge by later secured creditors concerning prior registration. Thus, the doctrine of constructive notice is applied to all creditors who obtain a registered charge. Such registered creditors will need to check the registry to determine whether there are any prior registered charges or risk having only a secondary priority to the collateral.

However, the combination of on registration of the unpaid vendor's charge and its superiority over registered charges causes problems to the secured transactions system created by the EBRD Model Law. One problem is that no lender with a mere registered charge can grant a debtor any real security value for the debtor's inventory unless the lender is willing to supervise the debtor's purchasing and bookkeeping operations to ensure actual payment of all suppliers. This would be very labor-intensive and increase the cost of inventory secured financing unreasonably. The same is probably true for loans no the debtor's equipment, although probably less labor-intensive and costly.

Thus, registered secured creditors such are mere lenders and not sellers of goods have only subordinate rights to inventory and equipment. Tat should make them hesitant to enter into the type of long-term, general purpose financing arrangements which can arise under secured transactions legislation. On the other hand, "trade creditors" and other credit sellers are well protected and should be expected to increase their sales and credit activity.

The "possessory charge" is the traditional pledge, but under the Model Law there are new twists to the doctrines and new problems. Almost every jurisdiction recognizes the security interest in which the creditor receives physical possession of the collateral from the debtor. However, the Model Law does not require any physical delivery by the debtor of the charged property to the creditor to create a possessory charge (even though the property must be "capable of delivery"). Instead, the Model Law allows the use of constructive possession, which may be held by "a person nominated by the creditor." Such statutory language could be used by a well-advised creditor to avoid registration and its incumbent fees and to use a simple agreement which nominates the debtor as the agreed person to hold possession. Thus, the Model Law's possessory charge subverts the non-possessory registered charge both because it provides a substitute which is too widely usable, and because it promotes secret encumbrances which destroys the heart of the registration system.

The EBRD Model Law is really a tale of two different kinds of creditors, credit sellers and lenders, which are given different status and rights. To understand the problems, a distinction must be made between these two types of creditors. A bank is a lender of money to a debtor, but a manufacturer becomes a creditor by selling goods on credit and becoming (in the word of the Model Law) an "unpaid vendor." The bank or other lender will get its rights to the collateral from the debtor through the secured financing agreement. The credit seller (unpaid vendor) will get its rights to the collateral by "retaining tile" to the collateral when it is sold and delivered to the debtor. Lenders have two costly choices: 1) to try to re-arrange the transaction so as to pass title through them; or 2) to supervise the debtor's financial operations enough to ensure payment of all trade creditors.

A credit seller can determine, before shipping goods to the debtor, that its claim to the charged property will have priority over those of all other creditors, because of the first to file priority rule. It cannot check the registration files and be certain whether there are any credit sellers with unpaid vendor's charges which have priority over its claims to inventory or to equipment, because those charges need not be registered; in effect they are secret liens.

The economic effect is likely to be that lenders either will not attribute any serious value to inventory or equipment as charged property, or they will have extra costs and risks in obtaining charges on such property, and these will be passed on to the debtor. Under the first approach, lenders will take charges on inventory and equipment, but will not reduce rates or make more credit available because of the problematic nature of nay actual economic recovery from such property. Such use of secured credit would not be cost effective.

Under the second approach, lenders could require the debtor to engage in periodic "pay-out and pay-over" transactions to obtain protection from unpaid vendors' charges, but such transactions are labor-intensive, costly, and not a cost-effective use of secured financing. Alternatively, lenders could devote much time and energy toward designing transactions are labor-intensive, costly, and not a cost-effective use of secured financing. Alternatively, lenders could devote much time and energy toward designing transactions which route "title" through them to the debtor, using bills of lading and other devises. The law of conditional sales and trust receipts has numerous examples of success and failure of such attempts. But these transactions, while imaginative, are not only risky but also costly, and should be eschewed if possible.

V. The North American "Security Interest"

The North American Model takes a different approach, covering all types of assets and all types of creditors under one statute, and expressing an equal preference for both credit sellers and lenders. The "security interest" covers all of a small business's assets, including equipment, inventory, accounts and intellectual property. Financing transactions in accounts are covered whether they are assignments of the accounts or sales. The first secured creditor to register its interest has priority over all other lenders.

Credit sellers are given a super-priority, but must register a public notice of their security interest within 20 days, and credit sellers of the debtor's inventory must notify all creditors who have registered their security interests before the sale. Enforcement is available through self-help repossession and through commercial sales which can be controlled by the creditor. However, the sale process must be "fair", and courts can judge the fairness of the process after the sale.

How well does this security interest stand up under the five-part functional analysis set forth in Part I of this paper?

1) It does not cost a lot to create an enforceable security interest which covers all of the assets of a small business? The collateral may be described generally, include after-acquired property and apply to future advances, with no required statement of a maximum amount. It requires filing of a "financing statement" in a public register, and that is a different document than the secured loan agreement itself. The fee for filing a financing statement is between \$10 and \$30 in most states, and it protects the secured

creditor for five years. The filing is purely an administrative matter, handled by clerks, and not subject to a review by judicial personnel.

2) Does it cost a lot to enforce the security interest? After a default, the secured party may exercise its rights either through judicial processes, such as a foreclosure action, or through non-judicial processes. Non-judicial processes include self-help repossession of inventory, rendering equipment unusable, and notifying account debtors to pay the secured creditor directly, rather than pay the debtor. . If the debtor objects to self-help repossession, the secured creditor must seek the assistance of a bailiff or other court official. Litigation concerning the exercise of these rights usually occurs after the rights have been exercised. Thus, the secured creditor can usually exercise its rights quickly without great cost.

The second half of this enforcement scenario is the sale of the collateral. The secured creditor has control of this sale, but must act carefully. The sale must be "commercially reasonable" in all aspects – time, place, manner, advertising, etc. – and all of this may be reviewed by a court after-the-fact. Thus, the secured creditor usually uses well-known commercial channels to sell the collateral, and they can be expensive.

3) Does enforcement of the security interest provide real commercial value for the creditor? The secured creditor controls the manner of the sale of the collateral, and will use normal commercial channels for that sale. This will usually realize greater value than the French system, where court enforcement officers are usually the only persons allowed to sell property free and clear of prior encumbrances. Although this sale process is more expensive, it uses the private sector to seek prices closer to market value. The increase in sale price by using the private sector is believed to be greater than the costs of using commercial channels for the sale.

In sum, the North American model has two aspects in the enforcement of security interests after default. One is self-help repossession, the other is creditor control of the sale of the collateral. Self-help repossession is probably not exportable to other parts of the world, but it is also less necessary in business financing. Voluntary repossession and resort to bailiffs and other court officials are usually adequate substitutes where the debtor is a business. The much more important aspect of the North American model is the secured creditor control of the sale of the collateral, which allows the creditor to use the private sector to seek prices closer to market value than the "distress sale" prices usually available through a judicial auction.

4) Is the secured creditor protected against the claims of third parties, including other creditors, bankruptcy officials, purchases and statutory claimants? The North American model sets forth a very complicated set of rules to determine priority among creditors. However, most of the complications arise out of specialized rules for agricultural loans, or loans where the collateral is "fixtures" or letters of credit rights or negotiable instruments. The rules for most ordinary secured loans are relatively simple. A secured creditor which registers its interest is protected against secured creditors who register later. There are two major exceptions, one for "purchase money security interests" (PMSI) which are used to finance the acquisition of a new asset. The other is for possessory security interests (e.g., a pledge).

A PMSI includes both credit given by a credit seller and credit given by a lender, if it is actually used to acquire collateral. It will have "super-priority" over a registered secured creditor, but only if it also is registered at the time of delivery or within 20 days thereafter. In addition, a PMSI secured creditor who sells goods which will become part of the debtor's inventory must notify all registered secured creditors of their intent to finance the debtor before the debtor receives the goods. Thus, although the registered secured creditor is subordinate to PMSIs, they are on notice of the existence of the PMSIs, either through a notification or through constructive notice.

Unsecured creditors are subordinate to a registered security interest, but not to an unregistered one. Bankruptcy officials have the same priority as a secured creditor who registers on the date the bankruptcy is field, so a secured creditor who registers before that date is protected. Wage claimants have no statutory priority, nor do tax claims. The tax authorities may register their claims, however, and be treated as secured creditors with priority dating from the time of their registration.

Purchasers of most collateral take subject to a registered security interest, and the secured creditor also has an interest in the proceeds of the sale – so it is doubly protected. There is an exception where the secured creditor has agreed to the sale, and this applies to sales of inventory. Thus, buyers of inventory take free and clear of even a registered security interest.

5) Can potential secured creditors determine, with certainty and at little cost, before the loan is made, whether any other creditor will have a better claim to the collateral? Under the "first to file" rule, the first security interest to be filed has priority over most other security interests. This is true, regardless of the actual knowledge by later secured creditors concerning prior registration, through the doctrine of constructive knowledge. Thus, a potential secured creditor can determine its priority by checking the register for "financing statements" already registered.

If there are none, the potential creditor will have priority over everyone – except possible PMSIs and possessory security interests. However, the exception for unregistered PMSIs will only apply to goods received with in the last 20 days. The PMSI creditor must register a "financing statement" covering its security interest within 20 days of delivery, or lose its "super-priority".

A possessory security interest (pledge) takes priority from the time the secured creditor takes possession. Thus, from the viewpoint of the potential secured creditor, it will have priority over pledges for all equipment and inventory in the physical possession of the debtor at the time it registers its security interest. It will not lose that priority, even if the goods are pledged and delivered to another creditor later. It will not have priority only as to goods not in the debtor's possession, but already in the possession of a pledgee, at the time the security interest is registered. Thus, the potential creditor, in addition to checking the register, must also inquire about any goods received in the past 20 days and any goods not physically present at the debtor's premises.

The potential debtor may lose priority over inventory sold, but it will continue to have a priority interest in the proceeds from the sale of inventory. It could also lose priority over new equipment and inventory acquired during the term of the loan due to PMSIs, but it will have either actual or constructive knowledge of these transactions. It can prevent such transactions by putting a "negative pledge" clause in the loan agreement, if it did not want the debtor to dilute the security interest.

VI. Conclusion

The French model "nantissement de fonds de commerce" is a security device which grants rights in equipment and intellectual property of a small business to the creditor. It does not cost much to create or enforce, although enforcement is subject to many possibilities for litigation. However, the value received from enforcement may be greatly reduced because the sale is through a judicial auction at "distress sale" prices, and because only parts of the business will be sold.

The secured creditor which registers its interest will be protected against unsecured creditors, bankruptcy officials and other mortgage - holders who register later. However it will not be protected against sales of the equipment to buyers, nor will it have a priority interest in the proceeds of the sale; and it may not have any interest in the replacement equipment. Further, it can be subject to statutory priorities for wage and tax claims. It will not receive either actual or constructive notice of the potential sales, or of the security interests in replacement equipment, or of wage or tax claims, so it cannot accurately plan for these contingencies.

The result of this lack of notice of other interests and the realization of reduced value on enforcement of the secured creditor's interests is that the secured creditor is not likely to value its interest in the collateral very highly. Thus, although the secured creditor will take a nantissement de fonds de commerce, it is not likely to give the debtor much value for it. The loan costs, amount and duration are not likely to be significantly different than those for an unsecured loan to the same debtor.

The EBRD Model "registered charge" is a security device which covers all the assets of a small business—equipment, inventory, accounts receivable and intellectual property. It does not cost much to create or enforce. A secured creditor can obtain voluntary repossession, immobilize collateral or obtain a bailiff's assistance without a court order, although enforcement is subject to many possibilities for litigation. The creditor controls the resale of the collateral, so that it is possible to realize actual commercial wholesale value of the collateral. The courts can review the resale to determine whether "fair value" was, in fact, realized.

The secured creditor which registers its charge will be protected against unsecured creditors, bankruptcy officials and other lenders who register later. It will also be protected against purchasers of collateral, except for buyers of inventory. However, it will not be protected against trade creditors who sell goods to the debtor on credit. They are given a priority interest for six months without registering their interest or notifying the registered secured creditor, and can extend that priority interest by registering it six months after delivery of the goods. These are also potential problems for the lender with regard to pledges, where possession is technically in the hands of a third party.

The result is that the registered charge does realize value for secured creditors at with little cost, but there is a question as to which creditors will receive that value. The trade creditor receives a "super-priority" for six months with no actual or constructive notice to other lenders of its interest. This should make the general lenders wary of assuming that their interests in the collateral are valuable. Thus, the small business under the EBRD Model will probably be liable to obtain credit from sellers, but not from more general lenders. This system will give some sellers a partial monopoly over credit transactions, and could lead them to impose monopoly pricing on their credit.

The North American Model "security interest" is a security device which covers all of the assets of a small business. It does not cost much to create ($10 to $30) or to enforce. It allows self-help repossession, which is probably not an exportable concept; but it also allows voluntary repossession, direct collection from account debtors, etc., and so is not dependent on self-help repossession. It also allows the creditor to control the resale of the collateral, so that it is possible to realize actual commercial wholesale value of the collateral. The courts can review the sale process used in the resale for its "commercial reasonableness", but cannot second – guess the price actually realized.

The secured creditor which registers its interest will be protected against unsecured creditors, bankruptcy officials and other lenders who register later. It will also be protected against purchasers of collateral, except for buyers of inventory, and will also have a priority interest in identifiable proceeds of any sale. However, it will be subject to sellers who sell to the debtor on credit, but only if the credit seller registers its interest (giving constructive notice) within 20 days of the delivery of the goods to the debtor, and for credit sales of goods that become the debtor's inventory, give notice to the registered secured creditor before delivery.

The result is that the registered security interest realizes real value to the secured creditor with little cost. Because of the requirements on credit sellers for actual and constructive notice to all registered creditors, lenders can effectively "police" their loans and prevent unwanted dilution of their security interests. In turn, that allows lenders and credit sellers to compete evenly for the business of debtors, and that competition will effectively reduce the costs of credit. In that manner, debtors are most likely to realize actual value for their collateral when they borrow.