

THE LAW AND ECONOMICS OF SECURED LENDING

The Law and Economics of Secured Lending

Frederic HELSEN



INTERSENTIA

Cambridge – Antwerp – Chicago

Intersentia Ltd
8 Wellington Mews | Wellington Street
Cambridge | CB1 1HW | United Kingdom
Tel.: +44 1223 736 170
Email: mail@intersentia.co.uk
www.intersentia.com | www.intersentia.co.uk

Distribution for the UK and the rest of the world (incl. Eastern Europe):

NBN International
1 Deltic Avenue, Rooksley
Milton Keynes MK13 8LD
United Kingdom
Tel.: +44 1752 202 301 | Fax: +44 1752 202 331
Email: orders@nbninternational.com

Distribution for Europe:

Lefebvre Sarrut Belgium NV
Hoogstraat 139/6
1000 Brussels
Belgium
Tel.: +32 3 680 15 50 | Fax: +32 3 658 71 21
Email: mail@intersentia.be

Distribution for the USA and Canada:

Independent Publishers Group
Order Department
814 North Franklin Street
Chicago, IL60610
USA
Tel.: +1 800 888 4741 (toll free) | Fax: +1312 337 5985
Email: orders@ipgbook.com

The Law and Economics of Secured Lending

© Frederic Helsen 2021

The author has asserted the right under the Copyright, Designs and Patents Act 1988, to be identified as authors of this work.

No part of this book may be reproduced, stored in a retrieval system, or transmitted, in any form, or by any means, without prior written permission from Intersentia, or as expressly permitted by law or under the terms agreed with the appropriate reprographic rights organisation. Enquiries concerning reproduction which may not be covered by the above should be addressed to Intersentia at the address above.

Cover design: Danny Juchtmans / www.dsigngraphics.be

ISBN 978-1-83970-150-4 (hardback)

ISBN 978-1-83970-152-8 (pdf)

D/2021/7849/68

NUR 822

British Library Cataloguing in Publication Data. A catalogue record for this book is available from the British Library.

FOREWORD

L.S.,

It is a great pleasure to present this book by my former assistant and Ph.D. student Frederic Helsen. The author obtained his Ph.D. in 2016 and has since updated the study in order to present it to a wider public. It is a rare combination of excellent economic (economic analysis of law) *and* legal scholarship. Moreover, not many studies have been devoted to an economic analysis of proprietary security interests, and this work appears to be the most comprehensive one in this field. Despite its length it is written in a concise and accurate style.

The study basically consists of two parts. The first part is a full-scale economic analysis of the problems and opportunities of secured lending, leading to a set of normative conclusions forming a functional design of an optimal system of proprietary security rights. The second part is a comparative study of U.S. and Belgian law on insolvency and more specifically proprietary security rights, including a comparative evaluation on the basis of the normative implications and evaluation criteria in Part I. Despite this evaluative perspective it is full of information relevant for legal practitioners dealing with secured lending. And above all, Frederic has made a wonderful contribution to legal and economic scholarship that is now available for others and could lead to further fruitful insights.

Matthias STORME
Prof. ord. KU Leuven

CONTENTS

<i>Foreword by Prof. Matthias Storme</i>	v
PART I. INTRODUCTION	1
Chapter I.	
Basic Economic Problem and Search for a Legal Solution	3
Section I. The problem of credit rationing	3
Section II. Structure of the search for a better solution	5
Section III. Approach and demarcation	6
Chapter II.	
Methodology	9
Section I. Overview	9
Section II. Law and economics	10
Section III. Comparative law	11
§1. On the method of comparative law	11
§2. Justification and method of comparing with US law	12
Section IV. Functionally integrated comparative law and economics	14
Section V. Concept of the debtor – borrower and decision maker behind the borrower	15
Section VI. Language	16
Section VII. Research questions	18
PART II. ECONOMIC FRAMEWORK	19
Chapter I.	
Secured Lending Theory: Preliminary Questions on the Efficiency of Security Interests	21
Section I. Introduction	21
Section II. Preliminary definition of security interest	21
Section III. Begging the question: The case against security interests	22
§1. Introduction	22
§2. Adjusting creditors	22

§3.	Non-adjusting creditors	24
A.	Overview.	24
B.	Involuntary creditors	24
C.	Voluntary creditors.	26
§4.	Intermediate conclusion	28
	Section IV. Efficiency explanations	28
§1.	Introduction	28
§2.	<i>Ex ante</i> : credible and efficient information gathering to reduce information asymmetry	29
A.	Information conveyance: Signaling and screening	29
B.	Specialization, centralization and screening	33
§3.	<i>Ex post</i> : dealing with collateral devaluation and agency problems	35
A.	Monitoring collateral	35
B.	Moral hazard: monitoring the debtor	37
§4.	Underinvestment problem	40
§5.	Increased liquidity to the benefit of all creditors	42
§6.	Covenants are usually insufficient	43
§7.	Conclusion	46
	Section V. Conclusion: current scholarship is insufficient	46
Chapter II.		
	Credit Rationing	49
	Section I. Introduction	49
	Section II. Historical evolution of credit rationing literature.	50
	Section III. Preliminary concepts	55
§1.	Methodological note	55
§2.	Starting point: adverse selection and moral hazard.	56
§3.	Adverse selection	56
§4.	Moral hazard	61
A.	Origins of the concept	61
B.	The logic of moral hazard	62
C.	A stylized definition	63
D.	Countermeasures to moral hazard.	64
E.	Distinction between moral hazard and adverse selection	68
§5.	Broad applicability of insurance logic	69
	Section IV. Credit rationing model based on adverse selection and moral hazard	70
§1.	The agency costs of debt – Asymmetry in pay-off between borrower and lender	70
§2.	Credit rationing caused by adverse selection and moral hazard	75
A.	Introduction.	75
B.	Sorting effect: adverse selection	76

C. Incentive effect: moral hazard.	81
D. Combined effect: non-price rationing	82
Section V. Definition	83
Chapter III.	
Why is Credit Rationing a Problem?	87
Chapter IV.	
Beneficial Effects of Security Interests on Credit Rationing	91
Section I. Overview and roadmap.	91
Section II. Reduce net risk exposure for lender	92
Section III. Reduce adverse selection	93
§1. Location in research methodology	93
§2. Reduce minimum risk factor $\hat{\theta}$ for feasible projects	93
§3. Self-selection, signaling, screening.	95
A. Outside collateral	95
1. Working hypothesis and assumptions	95
2. Self-selection, signaling, screening.	96
B. Inside collateral	99
C. Empirical criticism	100
Section IV. Reduce agency problems	102
§1. Location in research methodology	102
§2. Overview of types of agency problems and solutions offered by collateralization	102
§3. Overinvestment	104
§4. Asset dilution	107
§5. Claim dilution and subordination	109
§6. Misrepresentation of wealth.	112
§7. Better enforcement of covenants	112
§8. Failure to care for encumbered assets.	114
§9. Default	115
Section V. Reduce underinvestment.	116
Section VI. Reduce transaction costs	117
§1. Price setting	117
§2. Enforcement	118
Section VII. Reduce panic costs	120
Section VIII. Intermediate conclusion: Scope for efficiency benefits	122

Chapter V.

Costs of Security Interests. 125

Section I. Introduction 125

Section II. Transaction and monitoring costs 126

Section III. Inefficient value shifting and monitoring forbearance 127

§1. Recap: non-adjusting creditors 127

§2. Inefficient value shifting 129

Section IV. Monitoring and enforcement forbearance 131

Section V. Publicity inaccuracy 133

Section VI. Collateral-induced adverse selection 135

§1. The model 135

§2. Criticisms 137

 A. Possible positive selection 137

 B. Bootstrap security interests: Purchase money security 138

 C. Cost of collateral assumed to be positive function of its
 amount for risk-neutral borrowers. 140

Section VII. Opportunity cost 141

Section VIII. Overinvestment and excessive lending 142

Section IX. Skewing of incentives and costly preferences 143

Chapter VI.

**Normative Implications – A Functional Design of the Optimal Security
Interest System.** 145

Section I. Conceptualization of security 145

Section II. Enforceability 147

§1. Obligations require predictable, effective and efficient enforcement . . . 147

§2. Designing the procedure of forced execution on assets. 148

Section III. Transparency 157

§1. Overview 157

§2. Minimize inefficient value shifting 158

§3. Credible commitment to counter overinvestment 158

§4. Minimize scope for good faith acquisitions 159

§5. Implementation parameters. 161

Section IV. Flexibility 162

§1. Set-up 162

§2. Maximization of scope of collateralizable wealth and securable debt . . 163

§3. Negotiation and drafting 166

§4. Renegotiation, modification, redemption and transfer 170

Section V. (Re-)internalization mechanisms. 173

§1. Overview 173

§2. Suspect and fraudulent transactions. 174

§3. Protection of involuntary creditors	175
Section VI. Lender exposure	179
§1. Need for lender exposure	179
§2. Partial secured lender exposure does not eliminate all benefits of security	180
§3. Adjustable priority	181
§4. Carve-out or fixed fraction priority	182
§5. Countering excessive security	184
Section VII. Borrower exposure	185
Section VIII. Purchase money or “bootstrap” security	187
PART III. LEGAL FRAMEWORK	191
Chapter I.	
Location in Research Methodology.	193
Chapter II.	
General Principles of Bankruptcy.	195
Section I. Overview: Concursus and partial vs general insolvency	195
Section II. Concursus	198
Section III. <i>Paritas creditorum</i> , automatic stay, fixation and limitations on ability to dispose.	199
Section IV. Partial vs general insolvency	202
Section V. Exempt property	207
Section VI. Administrative expenses	207
Section VII. Discharge	208
Section VIII. Priority.	209
Chapter III.	
Mortgages.	213
Section I. Introduction	213
§1. Research focus of this chapter	213
§2. Methodology: dealing with Belgian and US law.	213
Section II. Definition.	214
Section III. General principles.	215
§1. Overview	215
§2. Property rights theory of mortgages.	215
§3. Mortgagor and debtor can be different persons	216
§4. (No) requirement of personal liability	217
§5. Accessory nature of mortgage to secured debt	222
A. Mortgage depends on existence of secured obligation	222
B. Scope of secured obligation demarcates scope of mortgage.	223

C. Defenses arising from secured obligation can be transposed to mortgage.	226
D. Accessory follows principal: security follows secured claim	229
§6. (Equity of) redemption.	230
§7. Underwriting standards	234
Section IV. Scope of possible secured debt	235
§1. General principle: very wide variety of debts is securable	235
§2. Temporal scope	237
§3. Personal scope	244
Section V. Scope of possible collateral	245
§1. Normative principles.	245
§2. Types of rights or interests that can be mortgaged.	246
§3. Temporal scope of rights and interests.	257
§4. Conditional or contingent rights and interests.	262
§5. Assets on which those rights and interests can have bearing.	264
Section VI. Creation of contractual mortgage	277
§1. Introduction	277
§2. Formal vs. functional approach.	277
§3. Competence to dispose of the mortgaged property interest.	287
Section VII. Conditions for enforceability <i>erga omnes</i>	292
§1. Basic principles of recordation.	292
§2. Special treatment of purchase money and retention of interest mechanisms	295
Section VIII. Robustness	298
§1. Introduction	298
§2. Transfer of the mortgaged property	299
A. Transparent transfer.	299
B. Intransparent transfer	306
§3. Transfer of the claim secured by the mortgage.	309
§4. Transfer of the mortgage itself.	310
§5. Appointment of receiver or sequester.	311
§6. Waste	313
§7. Subrogation and payments arising out of insurance or eminent domain . .	313
§8. Personal subrogation.	314
§9. Conflict with security interest in fixtures	319
Section IX. Termination of mortgage.	320
§1. Compliance with underlying obligation	320
§2. Acceleration of underlying obligation by the debtor: prepayment	321
§3. Termination by mutual agreement	327
§4. Termination due to external factors – subrogation	327
Section X. Enforcement and foreclosure	329
§1. Option to enforce on collateral and/or debtor personally.	329
§2. Acceleration by the creditor.	330

§3. Alternatives to foreclosure	334
§4. Market design of forced foreclosure	336
A. Overview.....	336
B. Offering free and clear title	338
C. Advertisement and open house.....	346
D. Mode of disposition: public or private sale.....	348
E. Credit bidding.....	356
F. Normative conclusions on market design.....	358
§5. Invalidation of the sale	360
§6. Right of redemption	365
§7. Order of priority.....	368
A. Overview.....	368
B. Scope of priority rules under analysis	369
C. Administrative expenses	371
D. Mortgages.....	376
E. Tax and regulatory claims and other statutory interests	379
F. Unsecured creditors who are a party to the foreclosure	382
§8. Wrongful, fraudulent and negligent foreclosure.....	382
§9. Deficiency recuperation	385
§10. Normative conclusions on enforcement.....	387

Chapter IV.

Movables.....	389
Section I. Introduction	389
§1. Borrowing against movables	389
§2. Research focus of this chapter	390
§3. Methodology: dealing with Belgian and US law.....	394
Section II. Definition.....	395
Section III. General principles.....	396
Section IV. Scope of possible collateral	398
§1. Expansive view of scope	398
§2. Different ways to analyze scope of application	399
A. By nature of the collateral	400
1. Movable – immovable.....	400
2. Tangible – intangible.....	401
3. Financial collateral	403
a. Overview.....	403
b. Deposits.....	404
c. Financial instruments	405
d. Credit claims.....	406
B. By time of acquisition.....	407
Section V. Scope of possible secured debts	410

Section VI. Obtaining a security interest – <i>inter partes</i> dimension	412
§1. <i>Inter partes</i>	412
§2. <i>Nemo plus</i> and the right to transfer property rights	413
§3. The agreement to grant security	414
A. Consensualism: agreement between the parties as a validity requirement	414
B. Evidentiary requirements	417
C. Signing – authenticating a security agreement	419
D. Agreement spread out over several instruments: composite document theory	422
E. Description of collateral	424
F. Possession, delivery or control	432
§4. Value given	434
Section VII. Enforcement outside of insolvency	434
§1. Introduction	434
§2. Default situation: seizure by unsecured creditor as a benchmark	435
§3. Secured creditor execution rights: self-help and appropriation	438
A. Introduction	438
B. Corporeal assets: disposition or appropriation	439
C. Debt claims – accounts	448
D. Financial collateral	451
E. Market design and procedure for disposition and appropriation	455
1. General principles and standards	455
2. Execution procedure	457
3. Market design of disposition	460
4. Judicial review	466
5. Consumer protection	468
Section VIII. Effectiveness of security interest against third parties (<i>erga omnes</i> dimension)	472
§1. Meaning of <i>erga omnes</i> enforceability	472
A. Concept	472
B. Priority in case of insolvency	473
C. Challenging transfers of the collateral	475
§2. Conditions for enforceability	476
A. Overview	476
B. Registration or filing	477
C. Physical possession	486
D. Control and notification	487
E. Automatic: (some) purchase money security interests	494
F. Priority revisited	495
Section IX. Robustness of security interests	498
§1. Overview	498

§2. Purchases in the ordinary course of business and/or in good faith	498
§3. Issues of identification of collateral – value tracing	503
§4. Discharge after execution	506
Section X. Conclusion	506
 PART IV. CONCLUSION	 511
 <i>Bibliography</i>	 523

