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## Security Interests

## Draft legislative guide on secured transactions

### Report of the Secretary-General

### Addendum

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# VI. Filing system

## A. General remarks

### 1. Introduction

1. As noted in Chapter V (see, for example, A/CN.9/WG.VI/WP.2/Add.5, paras. 6-7 and 23), security rights regimes in many countries provide for publicity of a security to be made by filing notice of the security in a public registry or filing system. The term, “filing system”, is preferred here to “registry”, to emphasize that, as opposed to an immovables registry, a filing system for most forms of movable property records notice of a security only. The filing system is a non-exclusive source of limited data and it is not the source of substantive property rights. It does not record information regarding the validity and nature of the grantor’s title; and it does not evidence whether the security right exists or even whether the described asset actually exists.

2. The filing system is the forum where an announcement or advertisement is made, alerting searchers to the possibility that a security right may exist (or be acquired in the future) in certain encumbered assets that the grantor has (or may acquire in the future) an interest in. As such, the filing system has to be understood to exist in the context of alternate sources of information (e.g. the grantor itself or credit information providers). The data that constitutes that announcement is referred to as a “notice”.

3. While the design and detail of the filing system will be determined by the substantive law of the particular security rights regime and may vary, its functions include:

(i) to provide a tool for assisting with priority determinations (see Chapter VII). An effective filing system allows prospective competing interests to determine quickly and easily what their priority would be;
(ii) to alert interested third parties to the possible existence, present or future, of a conflicting security right;
(iii) to decrease the risk of fraud; and
(iv) to serve as a precondition for enforceability of the security right against the grantor (see Chapter IX).

4. A system of filing a notice (i.e. limited data) rather than a copy of the financing transaction presents several advantages. It is fast, efficient and flexible. It minimizes the need for filing office resources, while maximizing privacy of financial details (see paras. 5-17; see also A/CN.9/WG.VI/WP.2/Add.5, paras. 22-23).

## 2. Key design issues

### a. Notice filing v. document filing

5. Assuming a notice filing system, as discussed above, is implemented, a security rights regime should state clearly that the term "notice" does not refer to a form or a document but to an aggregate of information. It should also state that notice may refer to one or more grantors and to one or more secured creditors, and that the effect of a notice is not limited to a single transaction.

6. Regarding the information to be included in a notice, the regime might require only the minimum data necessary to warn searchers of the possibility of another claim. Searchers, if they wish, can then obtain any further information required from other sources. Obstacles to access and excessive formalities should be avoided.

7. The data required for a notice to be legally sufficient might be limited to three elements: identification of the debtor (or grantor, in the case of a third-party grantor); identification of a name of a secured creditor; and description of assets in the notice. These elements are discussed below in further detail.

#### (i) Identification of the grantor

8. Identification of the grantor is most important, since the key to discovery of the notice by a searcher is the grantor's name (see para. 19). Many jurisdictions have an entity registration system providing a public record with the precise entity name and, quite often, the assignment of an identification number to the entity. Many jurisdictions also assign some identification number to each individual or use a birth date as an aid to identification. As an additional identification item, the identification number would assist searchers in determining whether a particular notice refers to the person with respect to whom the search is being made. This additional item need not be an element of legal sufficiency of the notice. This element might also include the grantor's address as a desired additional item, but again, this need not affect legal sufficiency. Additional issues may arise from the search logic that the system employs. For example, names of individuals are usually indexed in alphabetical order based on family name, while names of entities are indexed alphabetically exactly as presented. Filing rules will be needed to require the party presenting the notice to identify whether the grantor is an individual or an entity and, in the former case, which is the family name.

#### (ii) Identification of the secured creditor

9. The key to finding a notice should be the grantor's name, not that of the secured creditor. Identification of the secured creditor provides a method for establishing that a party that claims a benefit based upon the notice is indeed the party entitled to do so (the filing of the notice is for this party's future benefit). This element need not be the name of the intended secured creditor itself, but may be an agent (whose agency status need not be disclosed; this approach is of particular value in syndicated loans). While this information is not as important as identifying the grantor, if the notice provides misleading information regarding the identification of the secured creditor, the secured creditor may suffer the

consequences vis-à-vis the misled party, but this should have no effect on the legal sufficiency of the filing. An address for the secured creditor may also be desirable, though not as an element of legal sufficiency. If an address is required, the secured creditor should bear both the risk of loss actually caused to any third party by an incorrect address and the risk of non-receipt of any statutory communication to be sent to the secured creditor at the address provided in the notice (e.g. a notification of a purchase money security right).

**(iii) Description of assets covered in the notice**

10. The description of the encumbered assets in the notice need not be congruent with the description in the security agreement for the notice to be legally sufficient. Coverage by the notice does not expand the property rights created under the security agreement; it is the security agreement, not the notice, which creates the secured creditor's property rights and determines the scope of the encumbered assets. The grantor should be enabled to police against, and have adequate remedies for, any unauthorized excess of encumbered assets coverage in the notice. The stringency of this requirement should go only to whether a searcher would reasonably have been put on notice of the possible coverage of a potential conflicting claim. As long as the grantor is adequately protected, regulation of the description in the notice of encumbered assets should be relaxed, so as not to create unnecessary inefficiencies and risk of error. Therefore, the description need not be specific and may be by type or category of asset. This is particularly useful in the context of coverage of future assets. Moreover, detailed descriptions may be confusing and lead to error.

**(iv) Maximum amount**

11. Another element that is sometimes suggested is a requirement that the notice specify a maximum amount of secured credit that gains the benefit derived (in terms of priority) from the filing of the notice. Since this is frequently discussed in the context of the content of the notice, it is also examined here.

12. The advantage of setting a maximum amount in the notice is that additional credit can thereby be obtained, as other credit providers can secure other obligations with any value in excess of the stated maximum, without needing an inter-creditor agreement with the existing secured creditor (who otherwise would have priority ("would be senior"), having filed earlier). The disadvantage though of capping the priority attributable to a filed notice is that it complicates and increases the cost of obtaining additional credit from the existing secured creditor, who will often be the most likely and least costly source of additional credit (for a more detailed discussion of this matter, see A/CN.9/WG.VI/WP.2/Add.5, paras. 35-37 and Add.7, paras. 46-48).

**(v) Pre-filing**

13. A security rights regime should provide that a notice may be filed prior to the making of a security agreement, i.e. no obligation need exist at the time of filing. The advantages and disadvantages of "pre-filing" have been explained in Chapter V (see A/CN.9/WG.VI/WP.2/Add.5, paras. 24-28). The benefits of permitting pre-filing may well outweigh any concerns about protecting the grantor, in the event a filing made prior to the creation of the security right is rendered inappropriate

because the transaction has not gone forward. The grantor could possibly be protected by provisions requiring the secured creditor to provide a termination upon appropriate demand, similar to the provisions applicable when the secured obligation has been satisfied by payment.

**(vi) Domestic and foreign grantors**

14. A single filing system, covering both domestic and foreign grantors, as well as all types of grantors (i.e. every form of legal person as well as individuals), would maximize the efficiency of the security regime.

**b. Authority to file and signature**

15. A filed notice that has not been authorized by the grantor (or, in the case of a termination or continuation, by the secured creditor) should have no legal effect. However, a signature should not be a standard requirement for the notice to be effective.

16. Imposing a requirement of a signature would increase the obligations of the parties to the transaction, as well as administrative costs. Even if electronic signatures were provided for (so that the signature requirement did not of itself preclude electronic filing), a signature requirement might well make the process more expensive and cumbersome, particularly if the electronic signature provisions of a jurisdiction dictate a specific technology. In fact, a traditional signature requirement did not preclude forgery. Moreover, filing office personnel may be ill-suited to detect forgery, and the effort to detect forgery would be a diversion of scarce resources and would slow down the intake process for all filings.

17. In the rare case of a mischievous filing, an aggrieved grantor should be able to seek judicial relief. Further measures aimed at protecting the grantor may be provided, at a greater cost to the secured credit regime. One approach, for example, could be to give the grantor the right to initiate a process to expunge the unauthorized notice. In such a case, the filing office should be obliged to send a notification to the secured creditor identified in the notice. If the secured creditor did not respond within a stated period of time, the regime could provide for a judicial decision or an automatic deletion of the notice from the record. The deterrent effect of such a statutory penalty is likely to effectively limit secured creditor misconduct. In any case, in determining whether there should be greater protection for the grantor, legislators may need to weigh the magnitude of the risk of filer error, intentional or not, against the cost and risk of loss that might be suffered by secured parties due to grantor error (e.g. a grantor wrongfully filing a termination or wrongfully seeking deletion).

**c. Grantor- or asset-based index**

18. Traditional registries familiar to many countries, such as those for aircraft or patents, are fundamentally ownership registries that may also encompass transfers of rights that are less than full ownership (these registries are asset-based). Such transfers involve high value serial-numbered non-fungible assets, in contrast to much of the property that will be covered by the movables security regime, where individual description, even of tangibles, is difficult if not impossible, particularly

so if the regime covers future property. Use of asset description or serial numbers as the basis for the index in a general movables security filing system is impossible.

19. This leaves grantor identification as the basis for the index. This may be based on the grantor name, or, in some countries, grantor identification number (see para. 8), or even a combination of the two. This puts great importance on the grantor name being correct, which is a problem particularly in systems where the bulk of the filings can reasonably be expected to be against grantors who are individuals. This will depend on whether business is carried out in the sole proprietorship rather than in the entity form, and on whether the filing system covers passenger motor vehicles. The significance of the difficulty in providing the grantor's name with perfect accuracy will vary from country to country, depending on the existence of a mandatory identification or internal identification regime that could be the basis for a single reliable and verifiable name for each individual. In some countries, non-private identification numbers are issued to individuals; these might be used in addition to or in lieu of names. With respect to names of grantors that are legal persons, there is frequently a public registry of those entities that makes possible a single reliable and verifiable name.

20. Devising a filing system usable across borders would present issues relating to multi-lingual databases. Dealing with a multi-alphabet database may present more difficult problems, although within a particular jurisdiction, the issue of a multi-alphabet database is less likely to arise. These problems may be alleviated by the use of grantor identification by number or other element in view of recent technological advances.

21. With respect to certain types of high-value assets that can be individually identifiable, such as motor vehicles, there is typically an identification number issued by a government agency or other recognized and reliable source. In such cases, the grantor-based index can, with respect to those types of asset, be supplemented by an asset-based index, with identification of the encumbered assets by number being made a condition to priority over specified competing interests, particularly buyers.

**d. The filing process**

22. An issue that must be addressed at the outset is whether the filing system should be based on electronic filing, either exclusively or optionally, and whether it should accommodate input via paper filings.

23. There can be no dispute about the superior efficiency and speed of electronic filing. It appropriately shifts all responsibility for accurate data input from the filing office onto the filer. An electronic system can, upon filing, instantaneously process, index and confirm the fact of filing. It can also be programmed to reduce inputting errors on the part of the filer. This technology already exists and is in operation in several jurisdictions. There are significant cost savings in the operation and maintenance of an electronic system, once set-up costs have been met. With a view to encouraging the extension of credit by foreign credit institutions, an electronic system might facilitate even multinational searching.

24. While the utilization of computers in less developed countries may be limited, it is likely that higher volume filers (e.g. financial institutions) will have

access to computers. Given that, it is unlikely that any new system implemented in the future would involve paper input only. The additional operating costs and the added legislative complexity when both electronic and paper filing co-exist (e.g. dealing with time lags between presentation and availability for search, an issue that exists only with respect to paper filings) militate in favour of preferring exclusively electronic filing, though this is dependent upon the infrastructure in the jurisdiction.

25. Issues such as the location of physical facilities are also alleviated by electronic filing. Only one repository (whether filings are on paper or electronic) is necessary which should require few employees. A regime that provides multiple intake sites may encounter "proper place to file" issues (both *ab initio* and upon change of the determining factor) or, possibly, issues of simultaneous filings against the same debtor in different offices.

26. A regime might make clear the limited role of the system operator by specifying the only permissible grounds for rejection of filings. This issue is also mitigated by electronic filing, which eliminates human intervention in the intake process. Archiving, searching and reporting are non-discretionary tasks. Administrative staff should be fully cognisant of the differences between the filing system and traditional registries and all of their conduct should reflect those differences. The regime should also provide for the maintenance and destruction of records.

27. All design decisions should be tested against the general principle that the filing system, as a key element of an effective and efficient movables security regime, should be simple, transparent and user-friendly both for filers and searchers. Even in a purely paper-input system, the database can and should be computerized. Computerization provides more efficient record-keeping and searching and should prove less costly to operate. It also enhances the integrity of the system by diminishing the possibility of human error and misconduct.

**e. Duration of effectiveness of a filed notice**

28. Three options exist for the period of effectiveness of a filed notice. The period may be:

(i) of unlimited duration, ended only by the authorized filing of a termination;
(ii) or a fixed term (including infinity) selected by the filer initially, subject to extension by the filing of a continuation; or
(iii) a common statutory fixed term, subject to extension by the filing of a continuation.

29. Most personal property secured financing extends over a relatively short period, in many jurisdictions rarely more than five to seven years. It is, however, often difficult to foretell precisely how long the effectiveness of the filing may be needed, as some transactions are open-ended and others of a fixed term initially are often, by agreement or by reason of the debtor's default, extended beyond the due date initially provided for the credit. Consequently, when filers are empowered to select a term, they usually select a term longer than that fixed in the credit documents (higher fees are not a deterrent since debtors have to pay the filing fees as a cost of the credit extension).

30. Options (i) and (iii) have an administrative advantage, in that all filings are good forever or are good for a uniform fixed term, which avoids complications from individualization of the intake process (i.e. from having to deal with individual duration selections and, therefore, with fee variations and the consequent potential for rejections if the correct fee is not paid). Option (iii) has the further advantage of making the archive "self-cleansing" (i.e. filings expire after a period of time). This is important not only in the paper context but also for electronic systems. While electronic archive space is less expensive than that for paper files, storage is not the only factor. There is also the factor of retention in the database and furnishing searchers with information that is no longer useful. Moreover, when a filing's life has ended by virtue of having been permitted to reach the end of the fixed term without the filing of a continuation, issues relating to filing of terminations are avoided.

31. While it is an issue of lesser significance in option (iii), the termination of the effectiveness of a filing needs to be addressed in all three options. Terminations serve both the public purpose of clearing the archive of filings that are no longer effective (reducing the quantity of data provided in response to searches) and the private purpose of allowing the grantor to offer a clear record, showing no encumbrances (and therefore no existing priority), to a future credit provider. While the obligation of a secured creditor to provide a termination is a matter of substantive law dealt with in Chapter VIII (see A/CN.9/WG.VI/WP.2/Add.8, paras. …), any system built on the filing of terminations must provide protection against terminations filed erroneously (by the secured creditor identified in the notice or by a stranger) or mischievously filed (by the grantor). In some existing systems, the filing office must notify the secured creditor that a termination has been filed (the termination only becomes effective if the secured creditor does not seek to prevent that termination within a stated time period). This method imposes time and monetary costs on the parties. Alleviation of these costs requires determining which party shall bear which risks and burdens.

32. Upon full satisfaction of all of the secured obligations, the grantor must be entitled to obtain a termination from the secured creditor. A statutory penalty may be imposed on the secured creditor in the event of non-compliance (e.g. fine or liability to damages). An alternative approach, as discussed above (see para. 34), might require the filing office to notify the secured creditor of receipt of a termination, which, in the absence of an objection by the secured creditor, would become effective upon the expiration of a fixed period. This approach would require some system for adjudication in the event of dispute, and allocation of risk during the period preceding final adjudication. Credit suppliers will require reasonable notice from the filing office to minimize the risk of grantor mischief.

33. The security rights regime should clearly state what occurs if a secured creditor fails to file a continuation statement within the prescribed time, and should make clear the effect of lapse on the priority previously enjoyed by the secured creditor (which might differ vis-à-vis different competing claimants). The regime should also provide for:

(i) the method for accomplishing continuation and termination;
(ii) judicial or administrative cancellation;
(iii) the effect of, and method of dealing with, subsequent events such as, for example: a change in the name of the grantor; the transfer of

encumbered assets by the grantor; a change in location of the grantor or of the encumbered assets (to the extent these are relevant to the determination of the proper place for filing); or the need to amend the name under which the filing is indexed in the event of a change in the name of the grantor;
(iv) the method for dealing with other amendments (e.g. encumbered assets changes and party changes such as an assignment of the security interest by the secured creditor).

## 3. Other basic elements

### a. Public access to the database

34. In many countries, with respect to traditional registries, it is normal practice to oblige an inquirer to establish a *bona fide* interest satisfactory to the registrar in order to search. In some countries, access is limited in the context of rules that only regulated financial entities are entitled to the benefit of certain movables security devices. However, impediments to access, such as qualification by the filing office, may cause delay or inappropriate exclusion. Many persons having or considering any sort of dealings with the grantor may have legitimate reasons for seeking access to the database. As the notice provides only minimal data, privacy concerns are less significant. It is, therefore, important that the regime explicitly state that anyone may file or search the security rights filing system, without interference by its administrator.

35. Technically, the index and the database could easily be made available, at no charge, to remote searchers (excluding the ability to modify content). With respect to filing, the degree of security desired will influence the technological architecture of the system. In all events, any proposed restriction on access should be tempered by an objective to make the system user-friendly and a recognition that the goal of the movables security regime is to enhance the availability of lower-cost credit.

### b. Extent of detail in statutory text

36. Although the tasks of the filing office may be detailed, the regime need only regulate the basic intake, search facilitation and archiving responsibilities of the filing office. A balance must be struck between drafting simple and flexible regulation, and ensuring certainty and administrative transparency. The duties and obligations, discretion and performance standards of the system operator should all be clearly prescribed for by the regime.

### c. Fees

37. High filing and searching fees will undermine the policy objective of security transactions law reform to expand the availability of and reduce the cost of secured credit. Filing fees should be set at a low level to enable and encourage use of the filing system in the widest range of transactions.

38. Establishing the filing system as a revenue source (beyond cost recovery) would also run counter to an objective of promoting low-cost secured credit. Filing fees for financing statements designed to raise revenue are tantamount to a tax, borne by debtors, on secured transactions. The negative effect of stamp duties,

including the consequent incentive to avoid the dutiable format, provides instructive experience.

39. While cost recovery should be the ultimate purpose of any fees charged, this notion should be viewed in light of the overall goals of the legislation. If a substantial initiation cost is incurred in setting up the filing system, this should be recovered over a long period of time in order to keep the fee as low as possible. Ultimately, it is the debtor who bears the burden of the fee.

40. Numerous methods of payment are now technologically feasible and, to ensure simplicity and flexibility, as many alternatives as possible should be offered, ranging from pre-arranged accounts (with prepaid deposits) maintained by frequent filers to capability to use credit or debit cards or a form of electronic funds transfer.

41. From a process design standpoint, the simplest structure may be to charge a fee only at the time of the initial filing (leaving subsequent filings free of any additional fees). The single fee might be determined by dividing the expected operating budget for the system by the expected number of initial filings. While this approach does shift some costs to grantors whose filing circumstances are less filing-intensive (e.g. no amendments) from those whose circumstances do involve post-initial filings, overall simplicity for system users and for the filing office (plus the advantage of an early collection of the fee) support the adoption of this approach. Many existing systems already provide this feature to some extent by not requiring a fee for filing terminations (which also encourages the filing of terminations). A searching fee is not necessary if the system provides internet or similar remote access to the database for self-searching (which requires no particular service by the filing office, although there will be some general system maintenance). A system that permits remote access for searching the index and the database, free of charge, might charge fees for certification or for copies of items in the database.

### d. Public or private operator

42. Reluctance to increase government bureaucracy should not be a basis for rejecting the notion of a filing system as part of a movables security regime. As the role of the system operator is limited, the system need not be operated by a government entity. However, each jurisdiction should provide a method for supervision and control of the operator of the system, and allow users to seek review of filing office conduct or inaction (whether judicial, administrative, or a combination of the two). The review methodology should be accessible and expeditious. If an effective general review methodology already exists in the jurisdiction, the secured transactions legislation need not address this matter.

### e. Effect of registry error and allocation of risk of loss

43. If the system is exclusively electronic, there will be little opportunity for filing office error. Even in a paper-based system, experience has not revealed many known losses suffered as a consequence of filing office error. The domestic legal system might already generally provide for either liability (or some sort of mandatory insurance) or immunity for filing office error.

44. In any case, it would be advisable for the security rights regime to clearly allocate risks between filers and searchers on the basis of efficiency. In most cases, this would mean protecting the filer at the expense of the subsequent searcher, although this rule can be mitigated in certain cases if it is deemed desirable to do so. For example, a rule might provide that an indexing error does not preclude effectiveness of the filing. This approach might, however, be modified to provide that it does not render the filing ineffective but only subordinates it to a subsequent filer who can establish that it searched and was misled by the indexing error. The policy judgement is a matter of allocating the risks between the earlier filer and the later filer. Thus, a rule that imposes the risk of an indexing error on the first filer would likely produce the practice of each filer performing a follow-up search. This practice, however, would burden all filings with extra cost and delay, and burden the system with many additional searches. Whether this approach is sensible depends in part on assumptions made about the likely frequency of both error and subsequent additional financing. This is also partly a matter of efficiency of the system in the sense that the decision might be affected by the availability of a remedy against the filing office. In many jurisdictions, the filing office enjoys sovereign immunity, while in others, a remedy for government error is available.

### f. Proof of content of database

45. Proof of content of the database is a matter of the law of evidence. A rule on this subject may be helpful in some jurisdictions.

### g. Alternative systems

46. Alternative systems include special systems for land, motor vehicles, air and sea vessels, and certain types of intellectual property. Specific filing systems for these types of assets are designed primarily to assure ownership and may not be well-suited to the needs of modern finance (for a discussion of coordination between registries, see A/CN.9/WG.VI/WP.2/Add.5, paras. 41-43).

### h. Special issues in a federal State

47. While it is likely that a multi-unit State will have to confront special political problems and special choice of law issues, many of these issues can be rendered significantly less important by means of technology, particularly, if the filing systems can provide for a unified index and database (whether there is a single filing office or multiple filing offices).

### i. Non-discrimination

48. The system should be accessible to both domestic and foreign creditors for both filing and searching purposes. In this way, sources of credit will be expanded to include foreign credit institutions.

## B. Summary and recommendations

49. A notice filing system, as contrasted to a document filing system is more suited to a security rights regime. For efficiency and cost-saving reasons, the

information required might be limited to identification of the debtor, identification of the secured creditor and a description of the assets.

[*Note to the Working Group: On the issue of a maximum amount in the notice, pre-filing and types of grantor covered, see note to the Working Group at the end of Chapter V in A/CN.9/WG.VI/WP.2/Add.5*.]

50. A signature requirement for the legal sufficiency of a notice is not recommended, as this increases the obligations of the parties and administrative costs. A filed notice that has not been authorized by the grantor should have no legal effect. Other measures designed to protect the grantor may be introduced at a greater cost to the secured credit regime.

51. Much of the property that will be covered by a general security rights regime is not capable of individual description. This means it is not possible to use asset description as the basis for an index in a general security rights filing system, covering movables. The system may instead be indexed on the grantor name, an assigned grantor identification number or a combination of the two. This may be varied for those types of assets that can be individually identified.

52. A system based on electronic filing is highly recommended, for reasons of efficiency, ease of use and increased access. These advantages apply equally to filers, searchers and administrators.

53. Different approaches may be taken to the period of effectiveness of a filed notice. The period may be: of unlimited duration, ended only by the authorized filing of a termination; a fixed term (including infinity) selected by the filer initially, subject to extension by the filing of a continuation; or a statutory fixed term, subject to extension by the filing of a continuation. Certainty of the term of effectiveness is an important consideration, as is its termination. The regime should address the process for termination and provide remedies for misconduct. The regime should also provide processes for continuation and any amendments of the notice.

[*Note to the Working Group: The Working Group may wish to consider whether international registries should be established as part of the regime envisaged in this Guide and, if so, discuss the issue of coordination between national and international registries. In its consideration, the Working Group may wish to take into account the international registries foreseen in various treaties such as the Convention on International Interests in Mobile Equipment and the Assignment Convention (optional Annex).*]