Security Interests, Collateral and Debtors at Home and Abroad: Beyond the DC Filing Office

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More and more, counsel to secured lenders must be prepared to address the prospect of a foreign component in otherwise ordinary loan transactions. As companies carry out an ever-increasing portion of their activities across national borders, the institutions that finance these companies must adapt and respond to new deal complexity. The borrower, or one of the co-borrowers or guarantors, may be a foreign entity, or the lender may rely on collateral located overseas. When these situations arise, the work of the secured party’s counsel expands to include consideration of legal systems outside that of the U.S. alone. Counsel may be called upon to assist the lender in structuring the transaction within the bounds of applicable law, navigate a myriad of tax and licensing laws, balance the laws of multiple jurisdictions, and manage the foreign professionals that necessarily are involved.

I. LEGAL TRADITIONS

A. The common law is a tradition that relies on judicial precedent for application to new situations. Judges draw on the decisions and analysis of earlier judges in making their holdings, lending consistency and reliability to the law generally. The common law originated in England and spread widely through tradition, conquest and especially through that country’s colonialism. If a country was once part of the British empire, it likely has a common law tradition. Examples include the United States, Hong Kong, Singapore, India and Australia. The common law tends to be more protective of creditors’ rights than the civil law.

B. The civil law tradition is the oldest of the legal traditions, and can be traced back to Roman law. As the Roman Empire expanded, this tradition spread, and is now made up of three sub-traditions: French, German and Scandinavian. The French tradition, based on the Napoleonic Code, spread globally with Napoleon’s military activity and is now found in countries as diverse as Turkey, Egypt, Chile and the Philippines. The civil law is based on a system of statutes and codes developed by scholars.

II. STRUCTURING ISSUES

A. Of paramount importance to any secured lender is the enforceability and priority given to its security interests. Without recourse to the collateral that supports the obligation to repay the debt, the lender has nothing more than an unsecured promise

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1 The information contained in this presentation is general in nature, is not addressed to a client in an attorney-client relationship with the preparer or her firm, and does not speak to any specific transaction or purport to give specific advice. Legal counsel in the applicable jurisdictions should always be consulted for an actual matter.
to pay. The well-developed, and uniform, commercial lending laws in the U.S. fuel commerce by providing certainty for lenders.

B. Structuring a loan with a party or collateral outside of the U.S. involves a consideration of the applicable law of each jurisdiction involved once all the facts are known. Steps to take include:

1. Identify the borrower. Understand the nature of the legal entity.
2. Consider the location and ownership of potential collateral.
3. Identify the collateral by type.
4. Consider how inter-dependent the entities are.
5. Estimate transaction costs in light of risk and benefit.

Armed with the answers to these inquiries, apply the specific local law to achieve a structure providing the optimal balance of risk and cost.

C. The ability to obtain a guarantee or other credit support from a foreign entity may be limited by local law. Practitioners in the U.S. are familiar with fraudulent conveyance laws, which present an economic risk to the transaction. Overseas, it is much more than that. In some cases, if the directors of a company provide credit support for another’s debt without a proper showing of corporate benefit, or adequate capital, fines or even individual criminal liability may result. In leveraged buyout situations, financial assistance laws may prevent the target’s assets from serving as collateral for a loan used to acquire the stock of the target, or there may be exceptions to the application of these laws. Local counsel must be consulted to assist in properly structuring the transaction to avoid the application of the law, or to comply with the restrictions. For example, a leveraged buyout of an Irish company may involve a complicated procedure known as a “whitewash” to allow for the target’s assets to serve as the lender’s collateral.

III. TAX CONSIDERATIONS

A. The Deemed Dividend

Section 956 of the Internal Revenue Code may “deem” unrepatriated income which is earned by the foreign subsidiary as additional income of the U.S. parent if the foreign subsidiary provides a guaranty in support of, or offers its assets as collateral security for, a loan to the U.S. parent. The pledge by a foreign borrower of its assets or a pledge of stock of a foreign subsidiary by its U.S. parent will trigger section 956.

Taxes are assessed on “United States property”, which is a term of art in the tax code. It includes “an obligation . . . of a United States person . . .”.

A foreign subsidiary which is on the hook for the obligations of a U.S. borrower to its lender has taxable U.S. property: “any obligation . . . of a United States person . . . with respect to which a controlled foreign corporation is a pledgor or guarantor shall be considered . . . to be United States property held by such

controlled foreign corporation."\(^2\) Thus, taking a direct pledge of a foreign subsidiary’s assets or obtaining a guarantee of repayment by a foreign subsidiary can create a U.S. tax liability for the U.S. entity holding the shares of such subsidiary.

Furthermore, tax liability under section 956 also can be triggered by indirect encumbrances of the assets of a foreign subsidiary. “[T]he pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the [foreign] corporation if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the [U.S.] shareholder effectively limiting the [foreign] corporation’s discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business."\(^2\)

What exactly are the tax consequences of obtaining a pledge of a foreign subsidiaries’ assets, a guaranty by such subsidiary, or a pledge of more than two-thirds of the subsidiary’s voting stock? The tax code will require the U.S. shareholder of the foreign subsidiary to recognize a portion of the foreign subsidiary’s income as its own, even if such income is not actually repatriated. This amount will be the lesser of (1) the average value of the U.S. property held by the foreign subsidiary as of the end of the last four fiscal quarters, less any amounts previously included in the U.S. shareholder’s income under section 956, or (2) the U.S. shareholder’s pro rata share of the foreign subsidiaries’ income and profits.\(^5\) This means that the U.S. shareholder’s tax liability could be either the average balance of the loan over the last four quarters (i.e. the U.S. property held by the foreign subsidiary), or if such subsidiary’s earnings are less that the loan balance, the amount of those earnings.

Although the tax consequences of section 956 can be highly unwelcome, it is important to evaluate the financial history of the foreign subsidiary carefully in order to determine whether section 956 will in fact result in a deemed dividend to the U.S. shareholder.\(^6\)

- The U.S. borrower may be incentivized to minimize or eliminate the foreign tax liabilities of its foreign subsidiaries by keeping such subsidiaries’ net income as low as possible or non-existent, which results in little to no earnings and profits year after year.

- The earnings of foreign subsidiaries may need to be repatriated in order to allow the U.S. borrower to service its debt obligations, and so actual dividends may exceed deemed dividends.

- The U.S. shareholder may have elected to treat the foreign subsidiary as a U.S. tax entity for U.S. income tax purposes.

- Tax credits received by the U.S. shareholder for foreign income taxes paid by its subsidiaries may render the deemed dividend less consequential.

Successive net operating losses by the U.S. shareholder may shelter any deemed dividend.

Thus, in many scenarios a lender may obtain a foreign subsidiary’s assets as part of the security package without resulting in any material consequences for the borrower. Involving tax experts early in any cross-border transaction is highly advisable.

B. Withholding Tax.

In cross-border lending facilities, unlike in strictly domestic transactions, the issue arises as to which jurisdiction will impose income tax on interest payments. To mitigate lost tax revenue, most countries impose a withholding tax requiring resident borrowers to withhold and remit income tax from interest payments made to non-resident lenders. In many cases, however, this income is also subject to taxation by the lender’s government, effectively making the income subject to double taxation.

Lenders typically assign the burden of withholding taxes to the borrower by including a gross-up provision in loan agreements. These gross-up provisions mandate the borrower to make payments in full without any deduction or set-off for taxes. By including a gross-up provision, the lender ensures it will receive the same net amount after the borrower pays the tax as it would have received had no tax been imposed. While shifting the tax consequence to the borrower may benefit the lender, income from these cross-border transactions is still taxed twice.

In order to avoid double taxation and promote the flow of capital between nations, many countries have entered into tax treaties which jointly reduce or eliminate withholding taxes. Alternatively, some treaties allow the source country to impose a withholding tax but provide for a corresponding tax credit to offset the effects of double taxation7.

The following are examples of tax treaty rates between the United States and its six largest trading partners8. The chart indicates the withholding tax rate on interest that a borrower would be required to withhold and pay to its government as a result of a cross-border transaction. For example, where a U.S. bank lends money to a Japanese borrower, the Japanese resident would be required to pay its government 10% on the interest of the loan.

<table>
<thead>
<tr>
<th>Borrower’s Jurisdiction</th>
<th>Tax Rate on Interest (%)</th>
</tr>
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<tbody>
<tr>
<td>Canada</td>
<td>0</td>
</tr>
<tr>
<td>China</td>
<td>10</td>
</tr>
</tbody>
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7 See Joint Committee on Taxation (http://www.jct.gov/x-2-06.pdf)
8 According to the US Census as of April 2010.
Because withholding taxes can be in excess of 20% in some jurisdictions, parties should consider structuring the transaction to minimize or eliminate withholding taxes. As described above, the most direct method to avoid withholding tax is to ensure that the lender and borrower are residents of nations with a bi-lateral tax treaty. In some cases, it may be advantageous for a borrower to establish a subsidiary or holding company in a treaty nation before borrowing. Because establishing a location in a foreign jurisdiction may implicate other unintended income tax issues, consulting a tax attorney is advisable. A more extreme structuring option to avoid withholding tax is for the lender to establish a subsidiary in a country with an extensive tax treaty network. This may reduce or even eliminate the impact of withholding taxes but does not address any tax issues associated with repatriating that income, or other issues, whether legal, regulatory or political, resulting from the lender’s presence in the jurisdiction.

#### C. Thin Capitalization

An over-leveraged entity presents credit risk for the lender, but may also result in a reduction of tax benefits to the thinly capitalized borrower. Taxing jurisdictions lose out on tax revenue when a company takes on excessive debt and uses the deduction of interest to offset otherwise taxable income. To prevent this “leakage,” tax laws may limit or even disallow in full deductions for the payment of interest by an entity whose leverage exceeds a specified threshold. Unavailability of these deductions may change the economics of the transaction for the borrower.

#### IV. CREDIT SUPPORT

A. Financial Assistance Laws

Under English law (as well as the laws of many other jurisdictions), it is unlawful for a company to grant financial assistance to any person in connection with the acquisition of its shares or the shares in its holding company. There is no exhaustive definition of “financial assistance” but it includes specifically the granting of loans, guarantees and security by the company. The most typical example where financial assistance becomes relevant is where a bank is lending to a company to pay for the consideration required to acquire shares in another company. The giving of guarantees and security by that acquired company or any of its subsidiaries would be unlawful. It is also relevant if any of the bank financing is used to refinance debt used to acquires the shares originally.

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2 4.9% applies to loans made by banks and insurance companies and interest paid on publicly traded securities. 10% applies when the beneficial owner is not a bank and the interest is paid by a bank or the purchaser of machinery and equipment in connection with a sale on credit. 15% applies to all other circumstances. See [www.dits.deloitte.com/TaxTreatyRates/treatyRatesLocator.aspx](http://www.dits.deloitte.com/TaxTreatyRates/treatyRatesLocator.aspx).
Private companies are often afforded an exception to the restriction on giving financial assistance. The transaction will be possible upon the completion of a “whitewash procedure.” Each director of the target company declares that the company has net assets and that it can pay its debts as they become due. These declarations must be supported by reports from the auditors. The borrower often objects to undertaking this procedure if the acquisition debt is not a significant part of the overall financing as the cost of the auditors can be considerable. The lender must take a commercial view as to whether it needs to take the security over, or have recourse to, the affected company’s assets. In some cases the acquisition debt can be excluded from the security package for the overall transaction.

If a company is in breach of the financial assistance legislation, it is liable to a substantial fine and every officer of the company involved is liable for imprisonment, a fine or both. From the creditor’s point of view, any security or guarantees taken will be void and unenforceable. Be on the lookout for financial assistance issues whenever ownership of the borrower changes hands.

B. Corporate Benefit

Similar to fraudulent conveyance laws in the U.S., many jurisdictions require that a corporate benefit be present for a guaranty to be enforceable. The difference is that directors may have personal liability in some cases for acting without benefit to the corporation.

V. REGULATORY CONSIDERATIONS

Similar to the state-by-state lender licensing regime and requirements for perfection of security interests by filing in the U.S., a U.S. lender desiring to lend to non-U.S. entities or to obtain a security interest over the assets of such entities may be required by local laws of the foreign jurisdiction to obtain a license or governmental approval or file certain paperwork with the local authorities. Each foreign jurisdiction has specific licensing and registration requirements, making consultation with counsel in the jurisdiction critical.

Some jurisdictions tie the licensing requirement to the act of taking deposits, so that merely lending into the jurisdiction without offering deposit services is permitted. Others focus on the frequency of the lending activity by the outside lender into the jurisdiction, so that a “one-off” transaction would likely not be subject to licensure. In most cases, a security interest alone over collateral in a jurisdiction does not require licensing or registration of the lender. If license or notification is required, however, banking activities that are carried out without the requisite permits may result in fines, forfeitures, or even criminal prosecution, depending on the jurisdiction’s law. If it is not practical for a lender to qualify to do business in the jurisdiction, lenders might explore other facility structures that can be put in place, such as a risk participation in a fronting lender's loan facilities.

In one example of a country where licensing in not required, but qualification is desirable for other reasons, consider the United Kingdom. U.S. lenders are not required by U.K. law to obtain a license to lend to U.K. entities. Rather, the principal considerations for a U.S. lender lending money to an English company are tax matters and filings with the HM Revenue and Customs (the “UK Revenue”), a department of the British Government responsible for the collection of taxes. Loans by "non-qualifying" U.S. lenders to U.K. entities result in a 20% withholding tax incurred on interest payments. A U.S. bank or U.S. corporation (with pass through LLC’s, the ultimate owners need to be U.S. residents as well) will likely be able to qualify under the 2001 United Kingdom-United States Double Tax Treaty. To become a qualified lender under the Double Tax Treaty, clearance paperwork must be completed by the
U.S. lender before U.K. source interest can be paid without withholding. The U.S. lender completes a pro forma application for relief under the Double Tax Treaty, obtains a certification of U.S. residency through an IRS form, and sends the certified form to the UK Revenue. The UK Revenue takes a number of months to grant the relief (i.e. "perfect" the process) and then issues a direction to the U.K. borrower permitting it to pay interest to the U.S. lender without withholding. Generally, receiving the exemption can take upwards of four to six months. Lenders should keep this lead time in mind because until the U.K. borrower receives such formal direction, it must withhold 20% for U.K. taxes on all payments of interest. There is, however, a mechanism by which the U.S. lender can petition the UK Revenue for withholding payments to be returned, although this can take time. Another approach is to schedule the first interest payment on the earlier of six months or receipt of the requisite direction.

VI. DOCUMENTATION ISSUES

A. Engaging Local Counsel

See Appendix A for a suggested list of questions to submit to foreign counsel at the start of a transaction, or when the lender first considers doing business in a new jurisdiction. The more these questions can be tailored to a specific transaction, the more useful the answers will be.

B. Choice of Law

The lender must assure itself that a court in the borrower's (or guarantor's) jurisdiction will respect a choice a law of the lender's jurisdiction in the loan agreement, but the law of the obligor's jurisdiction may be the only practical choice of governing law for the security agreements, stock pledges and other agreements creating or evidencing collateral security, because of the likelihood that any enforcement action would take place in that jurisdiction.

VII. COLLATERAL

A. Collateral Value is Dependent on its Type

The value to a secured lender of collateral located offshore is highly dependent on its type. Because relatively few jurisdictions possess commercial lending laws as comprehensive as the UCC, the lender cannot assume that a first priority security interest is always possible or even permitted. In some jurisdictions, the ownership or mortgage of real property is restricted to nationals of that country. The concept of perfection by control over a deposit account may not be available or, the only way to take security may be via total control over the asset. The value of collateral consisting of intellectual property is highly dependent on the strength of local laws protecting that intellectual property. Consider the relative value of IP registered in the U.S. to that held in China. Retention of title laws impact the value of inventory collateral. Accounts receivable lending, so common in the U.S., is much more difficult elsewhere due to the lack of laws permitting floating liens over future receivables, over-riding anti-assignment provisions, or providing for payment rights upon notice. These issues likely underlie the prevalence of forfeiting as a financing device across Europe.

Offshore collateral for a U.S. loan transaction will also be impacted by currency fluctuations if local currency has declined relative to the U.S. dollar at the time enforcement is sought. Access to local courts, costs of enforcement, time zones and physical distance, as well as
political or country risk are factors that may work to devalue collateral for the lender. This valuation issue should not be overlooked at origination of the lending transaction.

B. Convention on the Assignment of Receivables in International Trade

In 1995 the United Nations Commission on International Trade (“UNCITRAL”) spearheaded an initiative to overcome the uncertainties and obstacles to international trade and finance created by differing national laws regarding the assignment of receivables. With the help of nongovernmental organizations such as the Commercial Finance Association, the UNCITRAL working group prepared the Convention on the Assignment of Receivables in International Trade (the “Convention”), which was adopted by the U.N. General Assembly on December 12, 2001.¹⁰

“The main objective of the Convention is to promote the movement of goods and services across national borders by facilitating increased access to lower-cost credit. In order to achieve this objective, the Convention, inter alia: (i) removes legal obstacles to certain international financing practices, such as asset-based lending, factoring, forfaiting, securitization, refinancing and project financing (e.g. by validating assignments of future receivables and bulk assignments, and by partially invalidating contractual limitations to the assignment of receivables); (ii) unifies assignment law with respect to a number of issues, such as effectiveness of an assignment as between the assignor and the assignee and as against the debtor; (iii) enhances certainty and predictability with respect to the law applicable to key issues, such as priority between competing claims; and (iv) facilitates the harmonization of domestic assignment laws by providing a substantive law regime governing priority between competing claims that States may adopt on an optional basis.”¹¹

The Convention targets specific areas of non-uniformity across national laws in order to enhance predictability and attract lenders to offer receivables financing to businesses which operate across borders. Several of these areas are highlighted below, along with descriptions of the relevant provisions of the Convention intended to provide certainty as to what an assignee’s rights are to an assigned receivable.

- **National laws currently have different requirements for a legally valid and effective assignment of a receivable to occur, including potential issues as whether and to what extent a debtor must be notified or the debtor’s consent must be obtained.** The Convention validates an assignment contract if such contract is formally valid under the law which governs it or the law of the country in which it is concluded.¹² The Convention itself does not require the notification of the debtor nor the debtor’s consent for the assignment to be effective, so long as the payment terms in the original contract are not changed.¹³ Further, the debtor’s obligation under the receivable is discharged by the debtor complying with the last payment instruction received, which means that the assignee will likely notify the debtor promptly.¹⁴ The contract may express deal with which party shall notify the debtor, or in the absence of such provisions, either the

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¹² Convention, Article 27.
¹³ Convention, Article 15(1).
¹⁴ Convention, Article 17(5).
assignor or the assignee may send the debtor notice of the assignment and payment
instructions.\textsuperscript{12}

\begin{itemize}
  \item **Some nation’s laws do not allow the assignment of future receivables arising from contracts not yet completed by performance, or the “bulk assignment” of receivables.** The Convention expressly permits assignments of future receivables and bulk assignments if such receivables are described such that they can be identified as receivables to which the assignment relates.\textsuperscript{16} The Convention provides that when such assignments are registered in public records, at a minimum the assignor, the assignee and a “brief description” of the assigned receivable are necessary.\textsuperscript{12} The Convention itself does not state how brief a “brief description” may be to qualify as sufficiently identifying such receivables. Article 7 provides that “questions concerning matters governed by this Convention that are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private internationally law.”\textsuperscript{15}

  \item **The enforceability and effect of “anti-assignment” clauses vary among jurisdictions.** The Convention expressly allows assignments “notwithstanding any agreement between the initial or any subsequent assignor and the debtor . . . limiting in any way the assignor’s right to assign its receivables.”\textsuperscript{19} That said, the assignor may still be held liable for such breach of such an agreement.\textsuperscript{20}

  \item **National laws accord different priority to the assignee versus another party asserting a claim in the assigned receivable.** Under the Convention, the “law of the State in which the assignor is located governs the priority of the right of an assignee in the assigned receivable over the right of a competing claimant”,\textsuperscript{21} including another assignee of the same receivable, a creditor of the assignor, or an administrator in bankruptcy.\textsuperscript{22} To assist in resolving priority battles, the Convention contemplates an international registry, or in the alternative, domestic registries in which registration of a receivable would have the same effect as if registered in the international registry.\textsuperscript{23} However, the Convention allows signatory states to elect to retain priority rules as between two assignees based on the time the assignment contract was executed or when the debtor was notified.\textsuperscript{24} Thus, the Convention may suggest further steps toward a consistent regime of priority rules, rather than actually implementing them.

Before the Convention can be relied upon, a minimum of five countries must ratify the Convention. To date, the only country to have adopted the Convention is Liberia.

\begin{footnotes}
\item[12] Convention, Article 13(1).
\item[16] Convention, Article 8.
\item[12] Convention, Article 4.
\item[16] Convention, Article 7(2).
\item[19] Convention, Article 9(1).
\item[21] Convention, Article 9(2).
\item[22] Convention, Article 22.
\item[23] Convention, Article 5(m).
\item[21] Convention, Article 42(1).
\item[24] Convention, Article 42, sections II and III.
\end{footnotes}
SAMPLE QUESTIONS FOR FOREIGN COUNSEL

I. Lending into a foreign country; obtaining a guaranty from a foreign entity - borrowers, co-borrowers, guarantors

Licensing/Qualification
- Is a lender required to be licensed in the jurisdiction, be qualified to do business, make any filings or otherwise obtain governmental consent to engage in the transaction, or to enforce its rights under any agreement it enters into?
- Will the lender be subject to tax or other liability by qualifying?

Legal Prohibitions
- Do any financial assistance laws in the jurisdiction exist that would inhibit the foreign entity from borrowing/guaranteeing debt?
- Are there restrictions on the ability of a foreign entity of this type to guarantee debt of an affiliated company?
- Are guarantor protections waivable?
- Are government consents or special director action required?
- Is a tax gross-up provision enforceable?

II. Perfecting on foreign collateral – Consider specific types: accounts receivable, inventory, intellectual property, economic/voting interests

Perfection
- How does one perfect on such a security interest? Pledge vs. assignment?
- Are there any requirements to notify a third party of a the pledge or assignment?
- Is the pledge or assignment required to be registered with a central authority or recorded on a public registry? Recommended?
- Must the security documents be in the local language, or is English acceptable?
- Are there associated fees to register or record a pledge or assignment?
- Regarding pledges of a foreign entity, can such pledges be deemed a guaranty?

Filing/Taxes/Reporting
- Is the lender subject to any taxes (e.g., stamp duty) as a result of the transaction?
- Must any required filings be updated (e.g., as new accounts/inventory are added)?
- Will the lender be subject to any reporting requirements in the jurisdiction as a result of the transaction?

III. Priority/Enforcement of a Security Interest

Priority
- Once the lender’s security interest is perfected, what type of priority does the lender have vis-à-vis other creditors? In bankruptcy?

Enforcement
- How do you enforce a security interest? Does the lender need to be licensed in the jurisdiction?
• Are self-help remedies available?
• Is the U.S. security agreement enforceable in accordance with its terms? Are any changes necessary to improve its enforceability in the jurisdiction?
• Will a court in the jurisdiction enforce a judgment of a U.S. court? Is it more favorable to have documents governed by local law?
• Does an automatic stay concept exist in bankruptcy to limit the lender’s ability to pursue its remedies after a bankruptcy proceeding is initiated?
Foreign Assets as Collateral: German Law Aspects

I. Different Methods for Obtaining a Security Interest

*German law does not have statutory rules regulating a uniform security interest concept*

*Instead German law relies on numerous legal constructions based on contract and property law to achieve a security interest in movable property – that is to allow creditors to seize and sell property to satisfy the underlying debt*

II. Pfandrecht / Pledge as to Movable Property

*Statutory – set out in §§ 1204 through 1296 of the German Civil Code (BGB)*

*German Civil Code pledge is an unconditional right (serving to secure a claim) to the movable property or rights of others which authorizes the creditor to satisfy its claim through the receipts derived from the sale of the pledged property or right*

*Pledgor need not be the debtor*

Two legal relationships where the pledgor is not the debtor:

*Obligation running between creditor and pledgor requiring the latter to pledge the respective property*

*This obligation can be contractual (set out in a security agreement) or statutory*

Statutory: e.g., Unternehmerpfandrecht – Artisan’s or mechanic’s lien BGB 647

*Legal relationship between the pledgor and the debtor with respect to the underlying claim, to the extent they are not the same entity*

*Pre-requisites and attributes*

*Can pledge all types of movable property*

*But not a specified quantity of a fungible product*

*Underlying claim to be secured must relate to property (vermögensrechtlich) such as a claim to payment*

*Cannot secure a right to title (dingliche Rechte) by way of a pledge*

*Possessory security interest*

*Pledgor has to give the pledgee possession of the pledged property –§ 1205 BGB*

*Possession involves the ability to actually control the property § 854 BGB*
Pledgor’s giving pledgee possession serves to notify the public of the pledge

No central registration of pledges serving to put third parties on notice

Pledgor can retain control of the pledge property to the extent it does so as pledgee’s agent / custodian (Besitzdiener)

However, pledgor must exercise such control on pledgee’s behalf and subject the pledgee’s instructions

Circumstances must alert public to fact that the pledgor is acting in a subordinated capacity subject to pledgee’s instructions

Situations where pledgee gets only “indirect” possession (does not have actual physical possession of the pledged property)

The distinction between direct and indirect possession can result in the pledgor actually keeping possession of the pledged property

Indirect possession

Owner of property has indirect possession under German law to the extent it gives direct possession to a third party (Besitzmittler – possession intermediary – like a bailor) (BGB § 868) – Examples:

Lessor gives “direct” possession to lessee and retains indirect possession

Debtor gives a court official “direct” possession of debtor’s property pursuant to an attachment, but debtor retains indirect possession

Debtor gives insolvency trustee “direct” possession, but retains indirect possession

Debtor having only indirect possession of movable property can still pledge that property (e.g., debtor owns property, but is renting it to a third party)

After pledging property to which pledgor has only indirect possession, pledgor continues to have an indirect possession

Pledgee also gets indirect possession - becoming pledgor’s Besitzmittler / bailor

Third party with direct possession retains direct possession, but becomes the Besitzmittler / bailor for the pledgee

Pledgor must give notice to the Besitzmittler next in rank

Substitute for giving pledge possession: giving pledgee joint possession (BGB § 1206)

Joint possession (Mitbestitz): when more than one entity has control over property (and access thereto) such that each party can use all of the property and thereby
limit the same right of possession belonging to the other parties – the rights of joint possession must be of the same rank or priority

Private access road serving several properties

Requirement of joint control (Mitverschluss)

Pledgor / owner cannot be able to exercise control over the pledged property without the consent of the pledgee (and vice versa)

Trustee contracts: a kind of trustee (Treuhaendler) holds the property for the joint possession of the pledgor and pledgee

Priority: pledge enjoys priority over rights of third parties in pledged property (BGB § 1208)

To the extent the pledgee is in good faith (did not have knowledge of third party rights and its failure to discover such third party rights does not constitute gross negligence) the right arising out of the pledge (Pfandrecht) will take priority

Limitations:

this priority does not apply where the pledged property was stolen, misplaced or otherwise lost

Where pledgor pledged indirect possession, the rights of the third party with direct possession take priority over the rights of the pledgee

Priority over other creditors in German insolvency proceedings (Abgesonderte Befriedigung der Pfandgläubiger)

§ 50 German Insolvency Code (“InsO”): Creditors which have obtained a pledge as to property belonging to the debtor’s insolvency estate are entitled to special settlement (abgesonderte Befriedigung) out of the sale of the pledged property with respect to the claim underlying the pledge as well as interest and costs.

The sale proceeds first go to paying off the claim secured by the pledge

Priority as to multiple pledges (BGB § 1209)

First in time rule – from the date of the creation of the pledge

Date of creation of the pledge is also determinative even though the secured claim is conditional or in the future

Extinction of the pledge

Pledge extinguishes with the underlying claim (BGB § 1252)
Pledgee is required to return the pledged property back to the pledgor upon extinction of the pledge (BGB § 1223)

Pledgor can demand return of the pledged property upon settlement of the claim owed to the pledgee, once debtor is entitled to repay the underlying claim

Settlement through sale of pledged property (BGB § 1228)

Pledge can satisfy the underlying claim through sale of the pledged property

Pledgee is entitled to proceed with such sale as soon as the claim is due in full or in part

Procedure as to the sale

Public sale § 1235

Attribution of the sales proceeds (§ 1247)

Sales proceeds first go to satisfy pledges in order of priority

Any remaining proceeds qualify as pledged property and must be returned to the pledgor

Special supplemental rules for pledging claims (§§ 1273 – 1290) and securities (1292-1296)

III. Transfer of title in collateral to creditor – Sicherungsübereignung

Transfer: Legal characteristics

The debtor or a third party (“debtor / transferor”) transfers to the lender / creditor (“secured party”) collateral which secures the lender / creditor with respect to a claim against the debtor (“underlying claim”) by enabling secured party to satisfy the underlying debt in the case of default through application of the proceeds from the sale of the collateral (“Security Transfer”)

With respect to outside world transferee becomes the owner / possessor - Eigenbesitzer

Both owns and possesses (controls) the property

Transfer of “indirect ownership”

§ 930 BGB:

§ 930 BGB permits an owner in possession of the property to substitute the delivery of the property to the transferee for purposes of effecting the transfer by entering into a
contractual relationship with the transferee which gives the transferee indirect possession (mittelbarer Besitz)

§ 930 BGB is the theoretical basis for the security transfer (Sicherungsübereignung)

§ 930 BGB is an in rem / property law provision in the German Civil Code

Debtor /transferor gives the secured party / transferee indirect possession - mittelbarer Besitz

Debtor / transferor retains actual physical possession (unmittelbarer Besitz)

Enables transferor to exploit commercially the collateral

Conditional security transfer is possible if parties so agree

Presumption is against conditionality

Auflöslösende Bedingung - aufschiebende Bedingung: condition subsequent / condition precedent – one does not imply the other

Security Transfer is contractual - not statutory

Historically frowned on by courts as an end run around the requirement that pledgor give possession to collateral to pledgee so as to alert the public

Earlier cases required some act of notice with respect to the transfer – so as to inform the public of the transfer (e.g., notarization)

Modern case law does not require notification or publication of the security transfer

Special kind of trusteeship which serves to benefit (secure) the trustee

A type of trustee relationship (Treuhand) arises between the secured party (quasi trustee) and the debtor / transferor in that the secured party acquires full ownership of the security, but for a specific purpose (securitization)

Einnützige Sicherungstreuhand:

A security trust for benefit of the trustee

Gives rise to fiduciary duties (Treupflichten) on part of secured party as quasi trustee

Fiduciary duties apply only as to the two parties – they do not affect third parties

No central registration of security transfers which enables third parties to take notice of the security interest
Parties can have the security agreement notarized and registered in the respective notary’s books (notariale Beurkundung), but that process will not put third parties on notice.

Registration with notary only serves to authenticate the respective document.

Registration with a German notary (or qualifying notary) is necessary to the extent the property being transferred requires registration with a notary in order to be transferred.

E.g., transfer of land and shares in companies.

Legal relationship between the security transfer and the secured underlying claim

Security transfer is separate and independent of underlying claim.

Invalidity of the underlying claim does not invalidate the Security Transfer from the in rem (dinglich) perspective.

Under German law a transfer takes place at two levels: contractual and in rem.

But invalidation of the underlying claim will give the transferor a claim for return of the transferred property - Rückgewähranspruch.

Invalidation of the underlying claim may invalidate the security agreement.

Demanding payment of the underlying claim is conditional upon return of the security.

Security agreement

No form requirements.

Can be oral.

Can be implied.

Content:

Nature of the contractual terms.

Einnützige Sicherungstreuhand: so the obligations owed by secured party to debtor / transferor take on a fiduciary character.

Specify the collateral.

Specify the underlying claim to be secured.

Sets out parties’ relationship as to possession.
Debtor / transferor retains direct possession

Secured party gets indirect possession

Sets out obligations of debtor / transferor with respect to collateral; e.g., maintenance and insurance

Addresses issue of “over kill”

Secured party does not need to become owner of collateral; only needs to be able to sell collateral in the event of debtor’s default on underlying claim

To reduce the some of the unnecessary ownership rights the security agreement usually sets out restrictions on the secured party’s ability to control and use the security

Restricts secured party’s right to exercise control over security until the right to “realized” (sell) the collateral arises

Such contractual restrictions only apply between debtor / transferor and secured party

They do not bind third parties who may purchase the collateral from the secured party

Obligation to transfer the collateral

Possible right of use for transferee

Obligation for secured party to return the collateral upon debtor’s satisfaction of underlying claim

Implied obligation

Procedure and rules for realizing (selling) the collateral:

Notice requirements

Method of sale

Debtor / transferor can waive any rights it have in advance to the right to recover surplus sales receipts over and above the underlying claim

Secured party simply keeps collateral when the right to realize (sell) the collateral arises

Security agreement is separate from the security transfer

Invalidity or unenforceability of the security agreement does not prevent the transfer

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Transfer still occurs pursuant to property (in rem) law (dinglich wirksam)

But transferor has a claim to recover the transferred property pursuant to the principle of unjust enrichment

Security agreement is separate from the underlying claim

*However, the security agreement often is contained in the loan agreement*

*Over Securitization*

Where the value of the transferred property greatly exceeds the underlying claim, the resulting over securitization invalidates the security agreement and, in turn, invalidates the security transfer on grounds of unconscionable pursuant to § 138 BGB (*sittenwidrig*)

Presumption of over securitization when the value of the security exceeds the underlying claim by 30%

*Where the security is subject to price fluctuation (e.g., seasonal goods) then an over securitization of up to 200 % will be tolerated*

In the case of unconscionability the entire security transfer is invalid, not just the excessive part

However, over securitization results in unconscionability only if the over securitization exists at the time of the parties’ entering into the security agreement

Over securitization arising after conclusion of the security agreement does not invalidate the security agreement, but, instead, gives the debtor / transferor a claim in the amount of the over securitization (“post security agreement over securitization”)

Over securitization can occur after conclusion of the security agreement either by partial extinction of the underlying claim or where the value of the security changes

Post security agreement over securitization occurs where the value of the security exceeds the remaining underlying claim (plus interest owed) by 10%

*Assignment of the underlying claim*

Assignment of the underlying claim by transferee / secured party does not result automatically in transferee’s rights in the security going over to the assignee

The third party acquiring the underlying claim must request that the original transferee also assign the security transfer

If the third party acquiring the underlying claim requests and receives assignment of the security transfer as well, such assigned rights in the security are subject to
any defenses which the original debtor / transferor of the security has under the security agreement

Transfer of the security by the secured party

The secured party can transfer the security, but the acquirer generally takes the security subject to the original transferor’s right to recover the security upon extinction of the underlying claim

Conflicts between more than one security transfer: Principle of Priorität

Priority verses Priorität

In English priority means a ranking of creditors

In German priorität refers to a rule whereby only the first transfer is valid

The first transfer invalidates subsequent security transfers

Realization (sale) of collateral (Verwertung)

If security agreement does not specify treatment, then pledge law as to “realization” (sale of the collateral) may apply, but only to the extent those provisions concern “trust – good faith” obligations (Treufplichten)

For example: § 1228 BGB (can’t sell collateral until underlying debt is due); § 1234 BGB (must give debtor / transferor notice of sale of collateral)

Transferee / secured party has obligation to maximize the realization so as to protect the debtor / transferor

The realization should only occur to the extent necessary to cover the underlying debt

Failure to respect the interest of debtor / transferor in the realization process gives rise to damage claims (§ 280 BGB)

Transferee / secured party has to get direct possession (unmittelbarer Besitz) in order to sell collateral

“Herausgabe” claim – Sec 985 BGB)

Expedited procedure where the judgment is immediately executable

Debtor’s failure to turn over collateral on demand gives rise to damage claim

Ways of “realizing” collateral:

Must follow the procedure set out in security agreement
If no procedure is specified in security agreement, then secured party can use any of the following three methods:

_Sale through public auction (pledge procedure)_

Violation of the “pledge” provisions as to public auction does not invalidate the sale with respect to the third party buyer

_Sale through private broker § 383_

_Execution based on an award for payment_

Parties can agree that the secured party can forego realization and simply keep the secured property (Selbsteintritt)

_Acceleration agreements_

_Agreements which authorize the secured party to transfer the collateral in the event of its not being paid in a timely fashion (even though they are entered into before the secured party has the right to realize the collateral) are enforceable in the case of security transfers_

Such acceleration agreements are invalid in the case of pledges

_Attribution of receipts:_

_Transferee / secured party can apply sale receipts to amount of open claim and costs_

_Any excess is to be returned to the debtor / transferor_

_Execution proceedings_

_Execution/ attachment proceedings by creditors of the secured party:_

If creditors of the secured party execute against the security and the underlying debt has been satisfied, then the debtor / transferor can defeat such execution / attachment proceedings.

_If creditors of the secured party execute against the security and the underlying debt has not been satisfied (but the secured party is not yet entitled to realize the collateral), the debtor / transferor can still defeat such execution / attachment proceedings._

_If creditors of the secured party execute against the security and the underlying debt has not been satisfied (and the secured party is entitled to “realize” (sell) the collateral), the debtor / transferor cannot defeat such execution / attachment proceedings._

Execution proceedings by creditors of the debtor / transferor
Secured party can prevent execution by debtor’s / transferor’s creditors until the underlying debt is satisfied

Debtor’s / transferor’s creditors can successfully execute against the debtor’s / transferor’s claim to recover (a) the security upon debtor’s / transferor’s satisfaction of the underlying claim or (b) the surplus sales receipts over and above the underlying claim

**Insolvency**

**Insolvency of secured party**

If the underlying debt is satisfied, then the claim which debtor / transferor has to recover the security falls outside of the insolvency proceedings (Aussonderungsrecht)

If the underlying debt has not been satisfied, but the right to “realize” (sell) the security has not yet arisen, the debtor / transferor’s right to recover the security upon satisfaction of the debt falls outside the scope of the insolvency proceedings (Aussonderungsrecht).

*So the debtor / transferor is free to pursue its rights as to the assigned claim pursuant to civil law*

If the underlying debt has not been satisfied and the right to “realize” the collateral has arisen, the insolvency trustee can realize (sell) the collateral, but must pay any surplus over the underlying claim to the original debtor / transferor

**Insolvency of debtor / transferor**

The insolvency trustee can sell the security (to the extent it is in the direct possession of the debtor / transferor), but the secured party has a right to special treatment with respect to the proceeds (Absonderungsrecht) (§§ 51 and 166-173 German bankruptcy code - InsO) – the secured party gets the same treatment as a pledgee

*The insolvency trustee is obligated to use the proceeds from the sale of the security first to satisfy the underlying claim in favor of the secured party*

*The insolvency trustee can let the secured party realized (sell) the collateral*

**Floating Lien**

Floating liens are a security interest retained in collateral even when the collateral changes in character or location.

Typically covers inventory and accounts receivable of the debtor in existence at the time of the original loan as well as inventory and accounts acquired by the debtor / transferor subsequent to the security transfer.
Floating charges with respect to inventory are viewed under German law as a sub-category of a security transfer (revolvierende Sicherungsübereignung).

In the case of a floating lien the security transfer applies to future inventory as well.

Excessive over securitization which occurs subsequent to the security assignment does not invalidate the assignment, but gives the debtor / assignor a claim to a partial release from the revolving security transfer (§ 307 BGB).

A presumption of excessive over securitization arises where the value of the revolving security exceeds the underlying claim by 150%.

IV. Security Assignments - Sicherungsabtretung

Debtor ("debtor / assignor") assigns a claim ("assigned claim") against a third party ("third party debtor") to a creditor of the debtor / assignor ("secured assignee") to secure the underlying claim which the secured assignee has against the debtor / assignor ("security assignment").

Security assignments derive their legitimacy from §398 BGB - which sets out the rules for the transfer of claims.

Legal characteristics

Trust relationship (Einnützige Sicherungstreuehand)

This type of security assignment gives rise to a trust relationship since the legal effects (full assignment of all creditor rights to secured assignee) exceed the intended effect, namely to enable assignee to sell the security and use the proceeds to satisfy the underlying claim.

Legal characteristics: Two perspectives

With respect to third parties:

Disclosed security assignments

If the third party debtor knows about the security transfer, then as far as the third party debtor is concerned the secured assignee has acquired all creditor rights to the assigned claim against the third party debtor.

Secured assignee can assign further the assigned claim.

Non-disclosed security assignment

If the security assignment has not been disclosed to the third party debtor, then the debtor / assignor retains (with respect to the third party debtor) the right to collect on the assigned claim.
The third party debtor’s payment of the assigned debt to the debtor / assignor satisfies the assigned debt and, thus, extinguishes the security assignment, provided the third party debtor was unaware of the security assignment.

Relationship between the debtor / assignor and the secured assignee:

*The secured assignee holds the assigned claim in a type of trust for the benefit of the secured assignee (einnützige Sicherungstreuhand)*

That trust relationship (and the respective security agreement between debtor / assignor and the secured assignee) will impose duties and restrictions on the secured assignee with respect to the assigned claim - Such duties and restrictions include:

- **Secured assignee can only make use of the assigned claim to the extent such use conforms with the purpose of the assignment; i.e., to provide security**
- **Secured assignee can only collect on the third party claim when the underlying claim is due and payable; i.e., the debtor / assignor has defaulted on the respective loan**
- **Secured assignee must inform the debtor / assignor before disclosing the assignment to the third party debtor or other third parties**
- **When collecting on the assigned claim the secured assignee must give to the debtor / assignee the excess by which the amount collected on the assigned claim exceeds the underlying claim**
- **Once the underlying claim is satisfied the secured assignee must assign back to the debtor / assignor any remaining part of the assigned claim**

Breach of these duties does not affect the third party creditor or other third parties. Such breaches only give the debtor / assignor a claim for damages against the secured assignee.

No central registration of security assignments which enables third parties to take notice of the security interest

Parties can have the security agreement notarized and registered in the respective notary’s books (*notariale Beurkundung*), but that process will not put third parties on notice

**Assignment is separate from underlying claim**

The existence of the underlying claim is not a condition subsequent with respect to the security assignment.

**The extinction of the underlying claim does not invalidate the security assignment**
No form requirements

Can be implied

Content:

Specify the conditions under which the secured assignee can collect on the assigned claim

*How late does the debtor / assignor have to be on payment as to the underlying debt*

*How much notice must secured assignee give before collecting on the assigned debt*

Third party debtor does not acquire any rights or defenses out of the security agreement between the debtor / assignor and the secured assignee

*Execution / Attachment*

*Execution / attachment proceedings by creditors of the secured assignee:*

If creditors of the secured assignee attempt to execute against or attach the assigned claim, the debtor / assignor can defeat such execution and attachment proceedings, so long as the secured assignee’s right to collect against the assigned claim has not vested (Widerspruchsrecht)

*Execution / attachment proceedings by creditors of the debtor / assignor:*

If creditors of the debtor / assignor attempt to execute against or attach the assigned claim, the secured assignee can defeat such execution and assignment proceedings (Widerspruchsrecht).

*Insolvency*

*Insolvency proceedings as to the assets of the secured assignee*

In the event the secured assignee’s assets become subject to insolvency proceedings, the assigned claim does not fall within the insolvency estate (Aussonderungsrecht)

*So the debtor / assignor is free to pursue its rights as to the assigned claim pursuant to civil law*

*Insolvency proceedings as to the assets of the debtor / assignor*

The secured assignee gets priority treatment as to attribution of the amounts collected on the third party claim (Absonderungsrecht)

*The insolvency trustee must first allocate those proceeds to the satisfaction of the secured assignee’s underlying claim*
But the third party claim does fall within the estate of the debtor / assignor (no Aussonderungsrecht)

Conflicts between security assignments (Principle of Priorität)

A prior assignment by the debtor - assignor invalidates subsequent assignments

Subsequent assignments are actually invalidity rather than taking merely a lower rank with respect to the prior assignment

Exception: extended retention of title

Although an extended retention of title is a form of security assignment, it invalidates other preceding security assignments

Floating liens

Floating liens with respect to accounts receivable are viewed under German law as a sub-category of a security assignment (Globalzession)

An advantage that the security assignment has over the pledge is the latter does not apply to future claims

Unconscionability issues (§§ 138 and 307 BGB)

Assignments of all present and future accounts receivable are generally not considered invalid under § 138 BGB on grounds of unconscionability

But such assignments can be unconscionable if they deceive and place at risk future creditors (provided the parties were aware of this resulting harm for future creditors)

E.g., Undertaking to assign receivables upon payment moratorium by the debtor is unconscionable

Excessive over securitization can result in the invalidity of the floating lien on grounds of unconscionability

That can occur where the floating lien exceeds considerably (150%) the underlying claim (§ 237 BGB)

For example, a floating lien providing security in the amount of 30 million Euros to secure an underlying claim in the amount of 10 million Euros might well qualify as unconscionable

Failure to disclose the floating lien does not in of itself render the assignment unconscionable
Excessive over securitization which occurs subsequent to the security assignment (in the case with revolving security such as the assignment of future receivables) does not invalidate the assignment, but gives the debtor / assignor a claim to a partial release from the security assignment (§ 307 BGB – Treu und Glauben with respect to general sales conditions)

V. Retention of Title

Principle:

Seller of movable goods retains or reserves title to the sold goods until the purchase price has been paid

UCC Section 2-401 specifies that a retention or reservation by the seller of title in goods shipped or delivered to buyer constitutes a reservation of a security interest.

Retention of title is oriented almost exclusively towards securing the seller of goods

Generally not amenable to lenders as a means of security

But retention of title can interfere with a lender’s security, especially as to security on a borrower’s inventory

German statutory provisions (§ 449 BGB)

From a contractual point of view a reservation of title constitutes a condition precedent whereby title first passes to the buyer when the purchase price has been paid in full

Sale subject to retention of title is not complete until title goes over with payment in full

From a property law perspective (sachenrechtlich) the retention of title results in the buyer getting immediately a contingent right (Anwartschaft) to ownership; full ownership passes to the buyer upon full payment of the purchase price. During this provisional period the buyer has direct possession as non-owner ((Fremdbesitzer)

From a property law perspective the seller has title subject to a condition suspensive. This contingent title is known as “retained title with right to claim possession” (Vorbehaltseigentum mit Herausgabean spruch) (§983 BGB)

The seller has indirect possession until the price is paid

In order to require buyer to turn over possession the seller must rescind the sales contract

Buyer’s failure to make timely payment is not enough to entitle seller to take back the goods
Seller can only demand return of the goods if seller has rescinded the sales contract

Retention of title under German law is the right to rescind the contract so as to give rise to a claim for return of the delivered goods

No requirement of publication

The parties can keep the retention of title secret

General presumption that merchants buy on credit subject to a retention of title

Reservation of title is invalid insofar as the transfer of title (extinction of the retention of title) depends on the buyer’s satisfying claims belonging to a third party, particularly a third party related to the seller

In that case only the retention of title is invalid, not the sale / transfer

However, it is possible to condition the extinction of the retention of title upon the payment of third party debts, if those debts are owed by an affiliate of the buyer.

Legal characteristics

Similar to the security transfer in that the secured party in both instances does not get “direct” possession (unmittelbare Besitz)

Buyer remains free to use and resell the goods prior to full payment, although passage of title is conditional on buyer’s payment of the purchase price

Unless the parties agree otherwise – see discussion of security agreement

Retention of title applies to the sale of most kinds of movable goods

Including removable components, inventory and individual machinery sold collectively with other machinery

Retention of title does not apply to non-separable components (wesentliche Bestandteile), land or rights (§ 853 BGB)

Bona fide purchaser takes free of the retention of title (§ 932)

It is possible to mark the goods as being subject to retention of title so as to exclude the requisite good faith

Retention of title is also defeated through the attachment or mixing of the goods with other goods as well as through the processing of the goods or their destruction

Specificity requirement (based on § 854 BGB)

The retention of title must identify the specific goods to which it applies
Retention of title cannot be revolving; it cannot apply to all present and future inventory of warehouse stock

Security agreement

Parties can to some extent deviate in the retention of title clause from the statutory provisions

E.g., the parties can agree to put additional obligations on the buyer

The terms as to the retention of title must be a part of the sales contract in order to be binding

In order for the retention of title to be valid, seller must impose that condition prior to delivery

Terms need not be express; they can be implied.

E.g., if prior sales transactions were subject to a retention of title

Seller can restrict the buyer’s right to use or transfer the goods subject to retention of title

General presumption that buyer can re-sell the goods prior to full payment; unless the terms expressly provide otherwise.

This right to resell goods is conditional upon the buyer’s desisting from entering into agreements with the third party buyer which make it difficult for the seller to get to those sales receipts.

Battle of the forms issues

General purchase conditions which categorically reject retention of title will be defeated if (a) the seller’s general sales conditions provide for a retention of title and (b) buyer both accepts delivery and knew or should have known about seller’s intention to retain title

Hybrid forums of retention of title:

“Passed on” retention of title (”weitergeleitet”)

When the buyer undertakes to carry out any resale of the goods in such a manner so as not to affect the seller’s retained title

Takes the form of a conditional transfer of title to the third party buyer

Unusual provision and under certain circumstances can be deemed unconscionable (§307 BGB – AGB)
Re-instituted retention of title (nachgeschaltet)

When the buyer resells the goods subject to a retention of title

Common with respect to sales up through a distribution chain

Generally the original seller gets no rights to the buyer’s claim against the new third party buyer

Unless the original seller required buyer to make all re-sales subject to a retention of title

Extended retention of title (verlängerter Eigentumsvorehalt)

Agreement between seller and buyer that when the retention of title is extinguished by a re-sale of the goods or their being processed or combined or fixed with other goods the claim arising out of the resale or the resulting new goods will take the place of the original goods

A comprehensive extended retention of title will address separately both the resale and processing scenarios

Retaining title to processed goods in the extended retention of title clause is particularly important since otherwise under German Civil law the buyer would acquire title to the material or goods which it processed and the seller would lose any rights in the component goods sold to the buyer (§ 950 BGB).

With respect to processed goods the extended retention of title clause provides that the buyer is processing the goods as the seller’s agent

Seller still owes fiduciary duties to the buyer with respect to its holding title

The resale part of the extended retention of title gives the buyer the right to resell the goods (in their original or processed form) in the ordinary course of its business and requires the buyer to assign the right to the re-sale proceeds

Often the seller authorizes the buyer to collect the proceeds on its behalf

With respect to claims arising out of the resale of the goods, the original buyer’s agreement to assign that claim to the original seller is a form of a security assignment.

A security assignment of a future claim:

Assignment occurs prior to the resale: (Vorausabtretung – Assignment in advance)

The assignment of the claim against the third party buyer is invalid to the extent the sales contract between the first buyer (reseller) and the third party buyer prohibits such assignment.
Exception: if both the original buyer (reseller) and the third party buyer are merchants and sold / purchased the goods pursuant to their businesses, then the original buyer’s assignment of the claim is still valid, despite an interdiction in the re-sale agreement (§ 354 (a) HGB.)

Priority / Priorität

If there is more than one assignment of a claim relating to the re-sale of goods, only the assignment first in time is valid

Current account retention of title (erweiterte Eigentumsvorbehalt)

The retained title does not extinguish upon payment of the full price of the goods for which the seller has retained title, but rather with payment of all or part of the claims arising out of a business relationship

Valid between merchants, but deemed unconscionable where the buyer is not a merchant

Over excessive securitization gives rise to a claim for a release

Insolvency

Effects of buyer’s insolvency on retention of title

Insolvency trustee’s discretionary right (Wahlrecht – 107) §

Insolvency trustee can at his or her discretion either require fulfillment of contracts entered into with the debtor prior to insolvency (if the contract has not been fully performed*) or the insolvency trustee can refuse performance thereunder (Wahlrecht - § 103 InsO)

Where the trustee requires seller’s fulfillment of a sales contract, the claim for the purchase price attains a privileged status of the same rank as the trustee’s claim for costs and remuneration (§§ 53, 55 InsO) (Massegläubiger).

* Note that a sales contract subject to retention of title has not been fully performed in so far as the price has not been paid by seller, since the retention of title will prevent title from going over to the buyer

Where trustee cancels a sales contract (in the event goods are subject to retention of title) seller can rescind the contract and claim return of the goods. Seller’s assertion of a claim for return of the goods results in removing the goods from the insolvency estate. (Aussonderung - §§ 47-48 InsO.) Seller then has full title and direct possession, and can then “realize” (sell) the goods pursuant to civil law.

This privileged treatment (Aussonderung) puts sellers who extend credit generally in a better position than money lenders (the latter receive “Absonderung” treatment
– the goods subject to retained title go into the insolvency estate, but the proceeds from their sale are first used to satisfy payment of the purchase price).

If the seller transfers the retained title to a bank who is financing the buyer’s purchase of the goods, the bank cannot get a “Aussonderungsrecht (removal of goods from the buyer’s insolvency estate), but rather enjoys only preferential payment treatment from trustee’s sale of the goods (Absonderung).

*Special notice requirements for insolvency trustees with respect to contracts concerning goods subject to retention of title (§ 107 (2) InsO)*

**Insolvency of the seller with retention of title**

Seller’s trustee cannot refuse performance by buyer (payment of purchase price) pursuant to § 10 InsO (§107 92) InsO). Rather buyer can require seller’s performance upon buyer’s payment of the purchase price; i.e., buyer can require seller to pass full title to buyer

**VI. Possible Conflicts between these Different Types of Security Interests**

Principle of “Priorität” applies to conflicts between the different types of security interests

The security interest first created invalidates all subsequently created security interests

*Subsequent security interests are invalid rather than inferior in rank*

Exception: as to retention of title

Conflict between a floating lien (including both security transfers as to inventory and security assignments as to accounts receivable) and an reservation of title (including extended retention of title) results in the invalidation of the respective security transfers and security assignments to the extent they affect the retention of title, even if the retention of title was created latter in time

Such invalidity of a floating lien can be cured if the integrated security transfers and security assignments accord priority to the extended reservation of title (including an extended retention of title)

Such priority can be given through the so-called “partial waiver clause” *(Teilverzichtsklausel)*

Exception: bona fide purchaser

Transfer of property subject to a security agreement (e.g., a security transfer or retention of title) to a bona fide acquirer generally extinguishes the security agreement
and gives the good faith acquirer full title (§ 932 BGB: Gutgläubiger Erwerb vom Nichberichtigten - good faith acquisition from non-entitled sellers)

Rule does not apply in case of theft or loss of property (§ 932 BGB)

Rule applies not just to BFP but also to lenders acquiring property pursuant to a security transfer

Debtor’s direct possession of the goods makes it reasonable for third party buyers to assume debtor had full title

Debtor has color of title since the original creditor permitted debtor to retain direct possession as to the goods

The “good faith acquirer” exception only applies where the re-seller gives the third party buyer possession of the respective property

Good faith acquirer must not have knowledge of the prior security interest or should not have had reason to know thereof

Gross negligence standard applies (§ 932 (2))

Commercial lenders which take a security transfer to secure a loan have a ”good faith” duty to investigate as to whether the collateral is subject to prior security interests

Failure to do so results in the commercial lender’s inability to assert the “good faith” acquirer exception

VII. “Upstream Security Interests in Germany and German Capital Maintenance Rules

Upstream (aufsteigende) security interests are security interests given by companies in their assets to secure loans made to an affiliate by a commercial lender

Such upstream security interests can violate German company law requirements as to the maintenance of capital levels (“Capital Maintenance Rules” – Kapitalerhaltungsregelungen)

Overview of the Capital Maintenance Rules

German law as to limited liability companies (GmbH) and as to stock corporations (AG) prohibit those respective companies from disposing of assets necessary to maintain their nominal capital

§ 30 GmbH: It is prohibited to dispose of assets which are necessary to maintain the nominal capital (Stammkapital)
Where a disposal results in the assets not covering the nominal capital, a “deficit balance” (Unterbilanz) occurs.

Nominal capital (Stammkapital) is one of the components of equity capital (Eigenkapital): nominal; reserves; accumulated profits.

Prohibition intended to affect principally payments to shareholders; but applies to any disposals.

§57 AktG: It is prohibited to pay back to the shareholders their capital contribution, if other elements of equity capital (in particular, retain earnings) are not enough to cover the disposal.

§57 AktG essentially prohibits payments to shareholders which do not come out of earnings (“Return of capital contributions” – Einlagenrückgewähr).

German companies need only maintain the minimum nominal capital set out in the respective company statute.

GmbH - § 5 GmbH: 25,000 Euro

Nominal capital must be specified in the Articles of Incorporation / By-laws (Gesellschaftsvertrag).

AG - § 7 AktG: 50,000 Euro

There is no prohibition of undercapitalization for doing business.

No requirement for companies to have enough capital to maintain their businesses.

They only need have the minimum nominal capital amount specified by statute.

But German companies do not generally state an artificially low nominal capital as a way of avoiding the Capital Maintenance Rules.

The company’s payment or giving advantage to shareholders so as to result in the company’s disposal of assets is referred to as “pay-out” (Auszahlung).

Determination as to whether a disposal of assets violates Capital Maintenance Rules; i.e., disposition results in a “deficit balance” (Unterbilanz) or a ‘return of capital contributions” (Einlagenrückgewähr).

“Deficit balance” (Unterbilanz) - § 30 GmbH.

Germany uses a balance sheet method of calculation – bilanzielle Erfassung:

Value of assets which exceed actual liabilities (including reserves, but not nominal capital and retained earnings or stock owned by the company).
Legal consequences of a “deficit balance” / “return of capital contribution”

Possible liability for managers and board of the subsidiary (§ 31 GmbHG)

Dispositions of assets resulting in a deficit balance (Unterbilanz) must be returned to the company.

If the company cannot get the disposed assets back, then management is liable.

Upstream security interests can result in a “deficit balance” (Unterbilanz) / “return of capital contribution” (Einlagenrückgewähr) with respect to limited liability and stock companies.

Giving security does constitute a payment or giving of advantage to shareholders for purposes of the Capital Maintenance Rules.

Dispute as to when the “pay-out” (Auszahlung) occurs in the case of the granting of an upstream security interest.

A security interest does not appear in the balance sheet until the risk of the security interest’s being exercised is so great as to require the entry of a reserve in the balance sheet pursuant to German accounting rules.

Although balance sheet analysis is determinative with respect to the existence of a “deficit balance” or a “return of capital contribution,” some commentators contend that the granting of a security interest constitutes payment for purpose of the Capital Maintenance Rules, even though the granting of the security interest does not immediately appear in the balance sheet.

Because the security interest negatively impacts on the affected company assets.

Avoiding Capital Maintenance Rules: Giving of adequate compensation by the shareholders to offset the disposal of assets (vollwertige Gegenleistung des Gesellschafters) - § 30 GmbHG; § 57 AktG

This solution consists of the shareholders giving the company compensation which replaces what the shareholders took from the company – “adequate compensation” (vollwertige Gegenleistung).

Such compensation usually takes the form of a claim which the company can assert against the shareholders (claim for restitution” - Rückgewähranspruch)

The claim for restitution offsets on the asset side of the balance sheet the assets taken by the shareholders.

When a reserve for the security interest gets entered on the liability side of the balance sheet, the claim against the shareholders for restitution appears as the offsetting entry on the asset side.
Since the calculation as to a possible “deficit balance” (Unterbilanz) is on an
counting / mathematical basis, a disposal does not result in a deficit balance
(Unterbilanz) to the extent the shareholders put back into the assets the equivalent
value taken out by the disposal

A “deficit balance” can only occur where the disposal of assets results in reducing the
assets

Burden of proof as to adequacy of the compensation is on the shareholders

New statutory language as to “adequate compensation” (vollwertige Gegenleistung)

Upstream loans: Recent revisions to the Law on Limited Liability Companies
(MoMiG) added to § 30 GmbH a provision expressly setting out the “adequate
compensation” rule (vollwertige Gegenleistung). This language expressly provides
that “adequate compensation” by shareholders prevents an upstream loan from
causing a “deficit balance” (Unterbilanz).

Commentators have concluded that this new statutory law (although appearing in the
Law on Limited Liability Companies – GmbHG) also applies to stock companies

This new statutory language as to the “adequate compensation” rule expressly
adopts the balance sheet analysis approach

A “deficit balance” (Unterbilanz) is calculated solely on the basis of the balance sheet.

Application of the “adequate compensation” (vollwertige Gegenleistung) rule to
upstream security interests

No case law has extended the new statutory language expressly to upstream security
interests

Some commentators maintain that the treatment accorded to upstream loans in the
new statutory language should not automatically be extended to upstream security
interests since security interests receive different treatment from that accorded to
loans under the civil law and accounting / balance sheet rules (Sutter and Masseli
WM Bd. 23/2010)

In case of an upstream security interest it is difficult to determine whether the
company’s “claim for restitution” (Rückgabeanspruch) against the shareholders
constitutes “adequate compensate” (vollwertige Gegenleistung) for the security
interest

Shareholders cannot commit to returning the security interest to the company, since
the security interest belongs to a third party

Upstream loans are much easier, since the shareholders simply commit to giving the
loan back
Consequently, the shareholders have to promise to give the company compensation which will cover the prejudice caused by the security interest.

But it is difficult to determine what is adequate compensation, particularly since liability under the security interest turns on a contingency – whether the parent company will default on the underlying loan.

One possibility is for shareholders to undertake to indemnify the company with respect to the security interest.

Under the German civil code a subsidiary has an automatic claim for indemnification when it grants a security interest in its assets to secure a loan to the parent.

Any time a contractor / agent incurs costs furthering the work undertaken for the principal party, the latter is required to compensate the contractor / agent. § 670 BGB.

Anyone who is entitled to compensation for costs which he or she incurred with respect to a project can demand indemnification against liability incurred with respect to that project. § 257 BGB.

What constitutes an “adequate” (vollwertig) “claim for restitution” with respect to an upstream security interest.

Viability of the claim for restitution

Are the shareholders in a position to pay.

Double –whammy: since the shareholders’ default on the underlying loan is what triggers the exercise of the security interest, there is little chance the shareholders can make good on the claim for restitution (Rückgabean spruch) once the security interest has been exercised by the secured party.

Viability is increased a bit if you take the date of the creation of the security interest as the point in time for determining the adequacy of the claim for restitution.

But viability even then is difficult: The point of getting an upstream security interest is because of the un-creditworthiness of the shareholders.

Especially where the security interest is given by the subsidiary in a crisis situation where the lender is seeking to shore up the parent’s collateral.

Point in time for determining the adequacy of the claim for restitution (Beurteilungszeitpunkt).

Depends upon when the pay-out to shareholders (Auszahlung) is deemed to occur:

At the time of creation of the security interest, or
upon the entry of the security interest in the subsidiary’s balance sheet as a reserve – when the risk of parent’s default on the underlying loan reaches a critical level (drohende Sicherheitenverwertung)

German courts have not definitively addressed this issue and no customary practice has developed.

Based on the balance-sheet method of calculation the pay-out occurs with the recording of the security interest as a reserve in the subsidiary’s balance sheet.

The new language in § 30 GmbHG seems to support the “balance sheet” approach in that it calls for balance sheet analysis in evaluating “deficit balance” and “adequate compensation.”

However, some argue that the balance sheet approach is limited to upstream loans and does not apply to upstream security interests.

Viewing the pay-out as occurring at the time of entry of a security interest in the subsidiary’s balance sheet appears at first glance as “lender” friendly since it would appear to enable upstream security interests to avoid the Capital Maintenance Rules at the time of the creation of the security interest.

Since no pay-out will occur until after the documenting of the security agreement, the security interest cannot result in a “deficit balance” / “return of capital contribution” at the time of its creation.

However, if the parent’s creditworthiness deteriorates, there is a considerable risk at that point that the pay-out will exceed the resulting claim for restitution – resulting in a “deficit balance” / “return of capital” – with possible liability for managers and boards.

By pushing out the point-in-time for determining the adequateness of the “claim for restitution” to when the parent’s creditworthiness has deteriorated, the chances are that the “claim for restitution” will be inadequate to cover the pay-out.

Viewing pay-out as occurring at the time of creation of the security interest

Some commentators say that a subsidiary’s giving a security interest to secure the parent’s loan is the equivalent of the subsidiary securing the loan and passing it on to the parent.

The pay-out under this analogy would occur at the time of the subsidiary’s giving the security interest (a subsidiary’s giving a loan to its parent constitutes a pay-out).

Viewing pay-out as occurring at the time when the security interest is created may initially seem “lender” unfriendly since the subsidiary’s giving a security interest to secure its parent’s loan results in a pay-out, which presents a risk of violating the Capital Maintenance Rules at the time of the creation of the security interest.
However, in practice this approach actually reduces the risk of a “deficit balance” / “return of capital contribution” since the resulting “claim for restitution” will be more viable at the time of the creation of the security interest than when the parent approaches default.

Avoiding a “deficit balance” / “return of capital contribution” at the time of creating the security interest by means of the shareholders’ giving an “adequate” “claim of restitution” (Rückgabespruch) does not eliminate altogether the risk of the subsidiary’s managers’ incurring liability on a theory other than a violation of the Capital Maintenance Rules (§ 43 (2) –general fiduciary duty)

Liability for managers and boards with respect to upstream security interest, even where there is no violation of the Capital Maintenance rules

Pertinent statutes: § 43 (2) GmbHG; § 93 (2) AktG

Case law: BGH WM 2009, 78 (concerned upstream loans – loan from subsidiary to parent)

Getting Security from shareholders as to the claim for restitution

*Getting security from the shareholders will increase the chances of the “claim for restitution” qualifying as “adequate” (vollwertig)*

*But that is not usually a viable option: if the shareholders had sufficient assets to secure the claim for restitution, they probably would not need the security interest in the first place.*

**Exception to the German Capital Maintenance Rules: Contractual dominance**

Second sentence of § 30 GmbHG: “Sentence 1 [Prohibition of asset dispositions leading to the reduction of nominal capital] does not apply where a contract of dominance or profit-siphoning exists ....”

To the extent a German subsidiary has entered into a contract with its parent allowing the latter to dominate and control the subsidiary (in the sense of mere instrumentality or alter ego under U.S. corporate law) or to siphon off profits.

The ability of a parent (typically by way of an inter-group contract) to dominate a subsidiary beyond the limits of independence and autonomy imposed by company law is a well established concept in German company law.

*Under German company law there is a recognition that business groups often times need to exercise an absolute control and siphon off any benefits from their individual member companies.*
However, in order to avoid company principles of independence and autonomy the dominance must be upfront - usually by way contract (“Group Contract” - Unternehmens-, Beherrschungs-, oder Gewinnabführungsvertrag).

Such domination (producing an alter ego situation) generally results in the parent assuming automatic liability for the subsidiary’s actions – similar to the liability resulting under the doctrine of piercing the corporate veil).

Since the Capital Maintenance Rules would impinge on subsidiaries’ ability to act as the instruments and alter egos of their parents, the new language in § 30 GmbHG suspends the Capital Maintenance Rules where parent and subsidiary have entered into an explicit relationship of dominance.

This “suspension” of the Capital Maintenance Rules can also apply between affiliates to the extent a dominance pervades through an entire group.

The Group Contract must be in place at the time of the “pay-out” to the parent or affiliate

i.e., either at the time of the creation of the security interest or at the time the security interest is entered into the subsidiary’s balance sheet as a reserve

Depending on which theory of “pay-out” the respective German court will adopt

Limitation on the “Group Contract” exception

Suspension of the Capital Maintenance Rules will not occur if the “Group Contract” is so disadvantageous to the dominated subsidiary that its existence is threatened.

Some commentators argue that to the extent the parent has not given the subsidiary an adequate (vollwertige) claim of restitution (Rücklageanspruch), then the Group Contract exception should not apply because the domination has been used by the parent in such a way as to threaten the existence of the subsidiary.

To the extent the adequacy of the “claim of restitution” is determined at the time the security interest is entered into the balance sheet as a reserve, it is unlikely that the “claim of restitution” will be adequate since the parent’s economic viability will have been compromised.

Limitation Language to avoid potential liability on the part of management

In order to exclude the risk that an security interest results in a “deficit balance” (Unterbilanz) / “return of capital contribution” (Einlagenrückgewähr), the German company giving a security interest on its assets for the benefit of a parent company can include “limitation language” in the security agreement which prohibits the secured party from exercising on the security interest if doing so results in a “deficit balance” (Unterbilanz) / “return of capital contribution” (Einlagenrückgewähr).
This “limitation language” prevents the disposal of assets resulting in a “deficit balance” (Unterbilanz) / “return of capital contribution” (Einlagenrückgewähr). By doing so the “limitation language” protects management and boards from potential liability for such “deficit balances” and returns of capital contribution.

However, such limitation language greatly limits the value of the security interest since the latter can only be exercised where the affiliate giving the security interest has sufficient retained earnings so as to avoid the exercise of the security interest’s causing a “deficit balance” or “return of capital contribution.”

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Introduction

The following is a study of filing systems in eight countries: Australia, Brazil, China, England and Wales, France, Japan, Mexico, and Spain. These countries were selected because they are among the largest trading partners of the United States, and they are representative of the filing systems emerging among countries that share similar legal traditions.

For each country, I will discuss the legal framework of the filing system, as well as how it functions in practice.

Canada, the largest trading partner of the United States, is not included. Canada’s Personal Property Security Act, a model law enacted in some form in every province except Quebec, is largely based on the pre-2001 version of Article 9 of the Uniform Commercial Code.

Australia

1. The Filing System: Legal Framework

Like England, Australia has a dual system of security interests: one system for corporate debtors, and another for debtors that are unincorporated businesses, individuals and partnerships. Charges created by corporations, primarily floating charges as in England, are governed by the Corporations Act 2001, Chapter 2K, which provides for most such charges to be registered in a national companies database maintained by the Australian Securities and Investments Commission (“ASIC”). The required documents, consisting of a standard form plus the instrument creating the charge, must be filed with ASIC within 45 days after the charge instrument is executed by the debtor, or the charge may become unenforceable.

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1 Types of charges registrable under the Corporations Act 2001 include the following: “(a) a floating charge on the whole or a part of the property, business or undertaking of the company; (b) a charge on uncalled share capital; (c) a charge on a call on shares made but not paid; (d) a charge on a personal chattel, including a personal chattel that is unascertained or is to be acquired in the future, but not including a ship registered in an official register kept under an Australian law relating to title to ships; (e) a charge on goodwill, on a patent or licence under a patent, on a trade mark or service mark or a licence to use a trade mark or service mark, on a copyright or a licence under a copyright or on a registered design or a licence to use a registered design; (f) a charge on a book debt; (g) a charge on a marketable security, not being: (i) a charge created in whole or in part by the deposit of a document of title to the marketable security; or (ii) a mortgage under which the marketable security is registered in the name of the chargee or a person nominated by the chargee; or (iii) a charge where there is an agreement in force under which the chargee (or a person who has agreed to act on the instructions of the chargee) controls the sending of some or all electronic messages or other electronic communications by which the marketable security could be transferred; (h) a lien or charge on a crop, a lien or charge on wool or a stock mortgage; (j) a charge on a negotiable instrument other than a marketable security.” Corporations Act 2001, §262(1).
Security interests, including those created by unincorporated debtors such as sole proprietors, partnerships and consumers as well as by corporations, are also governed by state laws. In New South Wales (“NSW”), the applicable state law is the Security Interests in Goods Act 2005 (“SIG Act”), which is unique to New South Wales and is reminiscent of the Canadian PPSA and former Article 9. The SIG Act repealed the Bills of Sale Act 1898 (which was modeled on the English Bills of Sale Act and governed chattel mortgages) and the Registration of Interests in Goods Act 1986 (NSW) (governing motor vehicles and boats) as to transactions occurring after March 1, 2006. It combined a variety of types of security in goods into a single legal form called, as in the UCC, a “security interest,” and provided for all instruments that create a security interest in goods to be registrable with the misleadingly named “General Register of Deeds” of NSW.\(^2\) Like the UCC and the Canadian PPSA, and unlike English law, the Corporations Act 2001, and prior NSW law, under the SIG Act, §26, filing of security interests is not mandatory for the security interest to be effective as between the creditor and the debtor, with the exception of agricultural mortgages, but is required to perfect and establish priority of the interest as against third parties. Filings under the SIG Act need have no expiration date and are not limited to five years as under prior law.

Separate statutes govern registration of mortgages on patents, trademarks and designs created by corporate debtors and ship mortgages.

The effect of the dual registration scheme is that in most cases, if the debtor is a corporation, two filings are required: one with the ASIC, without which a charge is void; and in NSW, another with the General Register of Deeds which is not mandatory but necessary to perfect. Dual registration is the rule throughout Australia, although outside NSW the system of security interests is more complicated, preserving distinctions among bills of sale, fixed and floating charges, mortgages, trusts, and hire purchase contracts and making local filing mandatory for the validity of the security.\(^3\)

Certain security interests are excluded from the ASIC registration system and the SIG Act. In particular, security interests in intangibles, other than certain types of intellectual property, are not subject to registration. Assignments of receivables are unregistrable, and security interests in receivables of unincorporated businesses cannot be registered. Retention of title by a seller is not covered by the system, either. Coverage of security interests in livestock and farm products varies from state to state, though the SIG Act does cover them. Under the SIG Act, security may be registered over any chattels personal, fixtures or other things capable of complete transfer by delivery (whether immediately or at any future time), but not a security over title deeds, negotiable instruments, choses in action, chattel interests in real estate, shares, or access licences in respect of water granted under the Water Management Act 2000. The SIG Act also does not cover hire purchase contracts, leases with an option to purchase or hire contracts (personal property leases) generally.

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\(^2\) The General Register of Deeds is the real property recording office of NSW, but the SIG Act expanded its function to include registration of personal property security interests.

\(^3\) A “hire purchase contract” is essentially a lease with an option to purchase used as a security device for what is intended as a sale of goods. The seller retains title until the purchase option is exercised.
2. The Filing System: Functional Aspects

Under the ASIC system, a form notice plus the original charge instrument or a copy must be filed. The documents are mailed or faxed to a facility in the Gippsland region of eastern Victoria State, about 500 miles south of Sydney and 150 miles east of Melbourne. The registration fee is about $35 plus $1 or $2 per page over 10 pages.

The form notice, Form 309, “Notification of details of a charge,” which can be downloaded at http://www.asic.gov.au/asic/asic.nsf, must include the maximum liability covered by the charge (if applicable), a description of the debt and the property charged, details about the chargee including name and contact information, and an authorized signature on behalf of the corporate debtor creating the charge. The charge document must be annexed to the form. The corporation can be domestic or foreign. Although the ASIC system is searchable electronically and documents are stored in .pdf format, charge documents cannot be filed (“lodged,” in Australian parlance) online currently. However, ASIC is in the process of implementing an online filing system for charges.

Unlike the UCC system, charges cannot be registered with ASIC until the underlying documents have been executed by the debtor.

The NSW General Register of Deeds is kept by the Registrar General of the NSW Department of Lands. The form of documents required is governed by the NSW Conveyancing (General) Regulations 2003. The filing must be accompanied by a Deeds Index Particulars Form which states the type of security instrument (e.g., bill of sale or agricultural mortgage), the date, and the parties involved. Agricultural mortgages, as to which filing is mandatory within 45 days, must be specifically identified as crop, livestock (“stock”), or aquaculture fish mortgages. If both agricultural and non-agricultural assets are mortgaged, the filing is identified as “agricultural mortgage (business)” but the mortgage document must state whether it applies to crops, livestock or fish. The General Register of Deeds can be searched online or over the counter at the Department of Lands office at Queen’s Square, Sydney for a small fee.

A separate Register of Encumbrances on Cars and Boats (“REVS”) is maintained by the NSW Office of Fair Trading.

There are over 200,000 personal property security filings per year in Australia. Australia’s Office of the Attorney General has established a Personal Property Security Division with about eight personnel who are working on legislation to establish a national registry and to adopt a national Personal Property Security Act modeled on the UCC and the Canadian PPSA. A draft statute commonly referred to as the “Bond Act” was proposed at a conference at Bond University in 2002. Three position papers were been circulated by the Attorney General’s Office for public comment, the most recent in April 2007. Legislative action to enact a national PPSA in Australia may be forthcoming in the near future.

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4 See NSW Department of Lands Circular No. 2006/02, February 2006.
5 See NSW Department of Lands Circular No. 2006/08, June 2006.
Brazil

1. The Filing System: Legal Framework

Nonpossessory security interests in the nature of trust receipts ("alienacao fiduciaria em garantia") are permitted as a method of financing the purchase of movable goods from third parties, and are normally used for financing auto dealers' purchases of automobiles for inventory, among other things.6 The purchase money lender serves as trustee ("fiduciante") and holds title to the goods to secure the loan, passing title to the debtor upon payment. To be valid against third parties, the alienacao fiduciaria must be evidenced by a written instrument recorded in the Registry of Deeds and Documents at the location of the creditor.7 Under the Public Registry Law, registration is required at the location of the debtor as well, and in the case of motor vehicles, registration is required both at the location of the debtor and with the Motor Vehicles Department.8

There are also three types of nonpossessory pledges in Brazil, and all require registration to be valid against third parties. Agrarian and livestock pledges (penhor agricola and penhor pecuario) resemble chattel mortgages, and are limited to two and three years, respectively. The pledge agreement must be registered with the appropriate public registry.9 Generally the agrarian pledge may cover agricultural machines and equipment, timber, growing crops, and harvested produce.10 If the real property on which the collateral is located is already covered by a mortgage, that fact must be noted in the agrarian pledge agreement for the latter to be valid, as the mortgage will have priority.

Since January 2006, to attract foreign investment in agribusiness, the certificates of deposit and warrants that were used for financing of agricultural production for over 100 years have been replaced by a new regime of “agricultural certificates of deposit” (CDA) and “agricultural warrants” (WA). Both documents are credit instruments representing deposited agricultural products.11 The WA is a pledge right.

Both documents must be registered in an electronic registration system within ten days from the date of issuance. Failure to register will result in cancellation of the documents. The registration procedure is intended to provide disclosure both of ownership and liquidity.

The industrial pledge (penhor industrial) may encumber machinery and equipment utilized in industry.12 A series of special statutes has extended this device to meat and its derivatives, pork products and fish, and each statute contains special

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7 Romney, supra, at 170; Alienacao Fiduciaria Law, supra, §1. .

8 Romney, supra, at 182.

9 Gerber, supra, at 695.

10 Codigo Civil art. 781 (1916, revised 1919).

11 For tax reasons, the CDA is a promise of delivery and not a document representing the underlying goods. Negotiation of CDAs and WA’s is also exempt from tax. See Christian de Lima Ramos, Agribusiness comes of age, GLOBAL TRADE REVIEW, vol. 3, Issue 4 March/April 2005, at 60-62.

12 Decree-Law of May 6, 1939, Decreto-Lei 1,721.
requirements. Registration is required in the Registry of Immovables.\textsuperscript{13}

Brazil is one of the few civil law countries that requires registration of conditional sales (\textit{venda com reserva de dominio}). Conditional sales must be recorded in the Public Registry of Certificates and Documents to be valid against third parties.\textsuperscript{14}

Brazil also has a limited form of securitization of agricultural and industrial obligations. “Rural credit \textit{cedulas}” and “industrial credit \textit{cedulas}” are certificates in the nature of debentures secured by both real and personal property, including inventory, used in agricultural or industrial enterprises.\textsuperscript{15}

A \textit{penhor} contract must describe the collateral with specificity, including serial numbers and other details if available. The reason is partly a pragmatic one: if collateral is transferred to a third party without authority, the secured creditor bears the burden of proving against the third party that the property is collateral.

Under the Bankruptcy and Restructuring Law,\textsuperscript{16} secured creditors rank above all other creditors as to the encumbered property, except for employment related claims (up to a per-employee total of 150 times the monthly minimum wage, currently equal to about $39,000 US) and claims relating to accidents which occurred at work.\textsuperscript{17}

2. Filing System: Functional Aspects

Registration is at the local level and can be cumbersome and time-consuming. Consequently, in practice the most common devices in Brazil that fulfill a security function are self-executing and do not involve registration. One is the \textit{duplicata}, a device apparently unique to Brazil that involves certified and negotiable copies of the invoice – one for each payment due - which are returned to the seller upon delivery of each installment of goods marked as accepted and stating the buyer’s undertaking to make payment.\textsuperscript{18} The invoices can be negotiated to a lender, a kind of factoring of receivables. Another is the bill of exchange (\textit{letra de cambio}). To circumvent registration requirements, “simulation” – disguising transactions of one kind that requires registration as a transaction of a different, and non-registrable, kind - is apparently widespread, as is reliance on such non-security devices as predated checks.\textsuperscript{19}

\begin{footnotesize}
\begin{enumerate}
\item Ibid.
\item Gerber, supra, at 706-07.
\item Law of August 27, 1957, \textit{Lei} 3,253.
\item Bankruptcy and Restructuring Law (Law 11,101/2005).
\item Bankruptcy and Restructuring Law, art. 83.
\item Law 5475, July 18, 1968.
\item See Boris Kozolchyk, \textit{Law and the Credit Structure in Latin America}, 7 VA. J. INT’L LAW 1, 11ff. (1966). As many as 60 percent of all checks issued in Brazil are said to be predated. Armando Castelar Pinheiro and Alkimar Moura, \textit{The Use of Credit Information in Brazil}, available at www.lacea.org/meeting2000/ArmandoCastelar.pdf. Issuance of an NSF check is punishable, and commonly punished, as a crime, and issuers of such checks are compulsorily disclosed by banks to credit information bureaus.
\end{enumerate}
\end{footnotesize}
1. The Filing System: Legal Framework

Prior to 2007, the legal underpinnings of the Chinese filing system were murky, scattered among the Guaranty Law of 1995, a Supreme People's Court Judicial Interpretation of the Guaranty Law, Procedures promulgated by the Ministry of Justice, and rules of the State Administration of Industry and Commerce ("SAIC"). The Real Rights Law of the People’s Republic of China, effective October 1, 2007, clarified the substantive law regarding chattel mortgages and other security devices, and the Enterprise Bankruptcy Law enacted in 2006 elevated the priority of security interests in corporate bankruptcy proceedings, but neither materially altered the existing law regarding the functioning of the filing system.

Creating and perfecting a security interest in personal property of an enterprise, typically a chattel mortgage, requires that the mortgage agreement be notarized and registered in a registry maintained by the Department of Market Regulation of the SAIC at the location of the debtor, and that a Mortgage Registration Certificate be obtained. Under the Real Rights Law, a mortgage of chattels comes into being upon execution of the mortgage contract, but until registration, the security interest is void against third parties. Specialized registries exist for aircraft, ships and motor vehicles. Notaries public are regulated by the Ministry of Justice.

Chattels that can be mortgaged and hence, the subject of registration include the “manufacturing facilities, raw materials, semi-manufactured goods and products of an individual industrial and commercial household or agricultural production operator.” Under the Ministry of Justice Procedures for Registration of Mortgages by Notaries Public (the “Procedures”), security interests in contract rights and accounts receivable also may be created and registered in the same manner. The Procedures also expanded the scope of what may be mortgaged (and hence registered) to include mortgages of many consumer goods such as gold and silver jewelry, home appliances and furniture, and of machinery, equipment, livestock and other business assets owned

21 Supreme People’s Court judicial interpretation of the Guaranty Law, dated December 2001 (the “Judicial Interpretation”), Art. 6(1). (The Judicial Interpretation appears to be in the nature of what in the U.S. would be called an advisory opinion but is binding under Chinese law.) If the mortgagor is not the obligor on the debt, the mortgagor nonetheless can become liable for a certain percentage of the debt if the mortgagor causes the mortgage to be invalid, e.g., by failing to cooperate in the registration process. Judicial Interpretation, Art. 7.
22 Ministry of Justice Procedures for Registration of Mortgages by Notaries Public (February 2002) (the “Procedures”).
23 See Arts. 109 and 132, Enterprise Bankruptcy Law, effective June 1, 2007, and Art. 170, Real Rights Law; but see Art. 189, Real Rights Law ("The registration of the mortgage prescribed in Article 181 of this Law shall not challenge the buyer which has paid a reasonable price in normal business operations and has obtained the property under mortgage.") China to date does not have a bankruptcy law covering individuals or partnerships.
24 Art. 189, Real Rights Law. In contrast, a mortgage of real property becomes enforceable between the parties only upon registration. Id., Art. 187.
25 Id., Art. 181.
26 Ministry of Justice, Procedures for Registration of Mortgages by Notaries Public (February 2002) ("the Procedures").
by individuals and non-enterprise organizations, evidently to facilitate consumer and small business lending.

Pledges also exist under Chinese law. Although pledges of most types of collateral require transfer of possession, pledges of "rights" such as receivables, securities, documents of title and instruments can be accomplished by execution of a written pledge agreement coupled with registration of the pledge.  

If (1) a security interest in personal property is created in favor of a non-Chinese enterprise and (2) the secured debt is denominated in non-Chinese currency, a second registration is generally required with the State Administration of Foreign Exchange ("SAFE"). Security for a debt owed by a wholly foreign-owned enterprise is excepted; so, for example, a security interest in assets of the Chinese subsidiary of a non-Chinese parent corporation would be exempt from registration with SAFE if the security interest secures a debt owed by the non-Chinese parent.

SAFE will not register a mortgage or other security interest in favor of a non-Chinese enterprise, and the security interest will be void, if the party providing the security is a financial institution not authorized to engage in foreign exchange security business in China, or if that party is an enterprise other than a financial institution and does not have foreign exchange income.

2. The Filing System: Functional Aspects

Registration requires that the parties file the entire contract in hard copy rather than merely a notice or abstract. Indexing is supposed to be completed within five days after receipt of the document. Online filing and searching are not available. Access to register documents in the Chinese filing system is generally confined to notaries public.

Searching the Chinese local registries is problematic for prospective lenders and purchasers of assets. The contents of security agreements are considered a private matter between the parties, and registrars are reluctant to permit non-parties access to them. The Procedures provide that the parties and "relevant persons" are to have access, but do not define who is a "relevant person." In practice, some registrars honor powers of attorney given by an interested party, while others require proof of litigation concerning the collateral before they will permit access to non-parties to the security agreement.

The problem of conducting a search is exacerbated by the fact that in many cases, the debtor is a state-owned enterprise controlled by the same local government that also controls the registry. Cases have been reported, for example, of registrars denying access to local registries to counsel representing creditors with interests adverse to the state-owned enterprise or other arms of the local government.

The Hong Kong and Taiwanese filing systems are radically different from the People’s Republic of China. Taiwan, in particular, has an active and functioning registration system in which over 1,000 documents were filed within a single three-

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27 Art. 223 and 224, Real Rights Law.
28 Judicial Interpretation, Art. 6.
month period from May through July, 2004. The usefulness of the Taiwanese system and the prospects for outsourcing of filing and searching are limited somewhat by Taiwanese law, which restricts filings to security interests that are created under, and governed by, Taiwanese law and to secured parties that are authorized to do business in Taiwan and have a physical presence there.\textsuperscript{30} The Hong Kong system is based on English law.

England and Wales

1. The Filing System: Legal Framework

Section 395 of the Companies Act 1985 required registration of charges on assets of corporate debtors with the Companies Registry within 21 days after the charge agreement was executed. The Act has now been replaced by the Companies Act 2006, but with little change with respect to registration of charges.

The most common method of secured debt financing is the floating charge, which differs from the UCC security interest in that registration does not lock in priority vis-à-vis third party purchasers and grantees of fixed charges in the same assets. While floating charges rank in priority among themselves according to registration date, the floating charge does not “crystallize” as a lien on assets until an event of crystallization, such as default, insolvency of the debtor, or levy by a judgment creditor.

With respect to assets of unincorporated businesses and consumers, charges cannot be registered, and the only way to perfect a security interest is registration of a bill of sale (a bill of sale creates a chattel mortgage; the “sale” is the nominal sale and transfer of title to the chattels to the mortgagee, subject to reconveyance when the debt secured by the mortgage is paid) under the Bills of Sale Act. Although a bill of sale registry exists, it is used mainly in the subprime lending market by lenders that lend against cars and other consumer goods, and the registry consisted until recently of a file of index cards and hard copy documents, although it now has been put on computer.

The following charges on corporate assets require registration in England and Wales:

- A charge to secure any issue of debentures. A debenture is an instrument issued by a company as evidence of a debt or other obligation. It includes debenture stock, bonds and any other securities of a company, whether or not it forms a charge on the assets of the company.
- A charge on uncalled share capital of the company. Uncalled share capital is the balance owing for shares that are issued partly paid.
- A charge created or evidenced by an instrument, which, if executed by an individual, would require registration as a bill of sale. A bill of sale is an instrument creating or evidencing a charge or mortgage over goods, including fixtures and agricultural crops in certain cases, but not ships or aircraft.
- A charge on land (wherever situated), or any interest in it, but not a charge for any rent or other periodical sum arising from land. Technically, land includes property.

\textsuperscript{30} Art. 12(1), Enforcement Law (Taiwan), Civil Code General Provisions.
• A charge on book debts of the company. Book debts are debts that in the ordinary course of a company's business are commonly entered in its books.
• A floating charge on the company's undertaking or property. A floating charge is a charge that does not affect the assets charged until some event 'crystallises' (fixes) the charge to a certain point in time.
• A charge on calls made but not paid. Calls made are demands for payment of any part of the balance owing in respect of shares which are issued partly paid.
• A charge on a ship or aircraft or any share in a ship.

Charges on land, registered ships and aircraft, and mortgages on certain types of intellectual property, must be registered in specialized registries.

2. The Filing System: Functional Aspects

Charges and chattel mortgages in assets of corporate debtors can be registered using Form 395 (Form 397 for charges securing debentures), available at http://www.companieshouse.gov.uk/forms/formsOnline.shtml. However, while many corporate filings can be done online, registration of charges still requires submittal of the original security agreement along with the form in hard copy, although an authenticated copy of the agreement will be accepted if the property to be encumbered is outside the U.K. and if the agreement was made outside the U.K.

Registration is done at Companies House, now located in Cardiff, Wales. Charges must be registered within 21 days after the date when the charge is created, although if the charge agreement is made out of the country an additional period is added to reflect the time it would have taken to transmit the documents to England.

Indexing is time-consuming and may be delayed due to the requirement that Companies House personnel compare the information in the Form 395 with the charge agreement and issue a certificate of registration that is conclusive evidence of filing. Unlike the American filing offices, Companies House can reject a filing if the information on the form does not conform in all respects to the underlying contract.

Searches of the charge registry can be done online through Companies House Direct, a service provided by the registry, at nominal cost.

The requirement that the original charge agreement be submitted to Companies House was criticized in a recent Law Commission report, which recommended conversion to an all-electronic system with a facility for including terms of the charge agreement if desired, and elimination of the Registrar’s task of comparing the form with the underlying contract and issuance of a certificate.31 The Law Commission also recommended extending the registration system to sales of receivables, eliminating the 21-day deadline for registration, and conforming the legal frameworks for security interests granted by corporate and individual debtors. To date, however, these changes have not been made.

Registration of charges and searches of the records usually are done by solicitors (lawyers), although some credit bureaus also provide search and registration services to creditors.

Over 197,000 charge and chattel mortgage documents were registered with Companies House in the 2003-04 fiscal year. Companies House charges a fee of 28 pounds per registration. Registrations of bills of sale grew in volume from 2,840 in 2001 to over 20,000 in 2005, primarily due to the growth of the subprime market for asset-based consumer loans. Presumably the collapse of subprime lending has impacted the number of filings more recently.

While 197,000 is a significant figure, this compares unfavorably with over 465,000 financing statements filed during the same period in New Zealand’s Personal Property Security Register, which is modeled on the Canadian filing system. The Law Commission’s view is that the number of filings is restrained by the burdensome amount of information required in the Form 395, the 21-day deadline, and the requirement that the original charge agreement be submitted for registration with the form and that they be scrutinized at Companies House for consistency. Over 3,000 filings are rejected annually as late.

France

1. The Filing System: Legal Framework

Since the early 20th century France has had a registration system for enterprise liens, called nantissement de fonds de commerce. A nantissement de fonds de commerce blankets most tangible and intangible personal property of a company, including among other things equipment, intellectual property, leasehold rights, trade name, and customer lists, but not to fluctuating assets like accounts receivable and inventory. There is also a nantissement artisanal for artisan-type businesses but it is used rarely in practice. A nantissement de fonds de commerce or nantissement artisanal must be registered with the Registre du Commerce (commercial registry) of the local Tribunal de Commerce (Commercial Court) within 15 days of its creation or it is void.\(^{32}\) Registration is in the departement (judicial district) where the debtor is incorporated (immatricule), and if not incorporated, where it has its headquarters or domicile.\(^{33}\) There is no national filing system, and there are 95 departements.

A “special charge” may also be created in machines and industrial and professional equipment, and it, too, must be registered with the clerk of the Commercial Court within 15 days.\(^{34}\)

Special centralized registries exist for ships, aircraft and motion pictures, and there are separate registries and registration procedures for motor vehicles.

Registration with the clerk of the Commercial Court is required for a pledge of shares in a societe civile, one type of French corporate entity, but not for pledges of shares in other types of corporations such as the S.A. (societe anonyme) or S.A.S. (“simplified” S.A.), which must be registered on the books of the company or, in the case of shares in a societe a responsabilite limitee (which I believe is like an American limited partnership), perfected by service of notice by a court bailiff (greffier).

\(^{33}\) As between the headquarters and domicile, applicable law leaves it to a case by case determination.
\(^{34}\) Law of Jan. 18, 1951.
Before the *Loi Dailly* of 1961, a *nantissement* in accounts receivable could only be perfected by both registering with the tax authorities and sending the bailiff out to serve the account debtors. Under the *Loi Dailly*, such security interests in receivables were normally perfected by having the debtor execute a notarized deed of assignment by way of guarantee (*bordereau Dailly*) and deliver it to the lender. Registration was not required. However, lenders not qualified as financial institutions in France were not able to use the *bordereau Dailly* and had to use the old procedure, which is impracticable for obvious reasons.

A Supreme Court decision dated December 19, 2006 invalidating assignments of accounts receivable unless specifically authorized by the legislature threw the status of assignments of accounts receivable under the *Loi Dailly* into severe doubt. However, the French legislature stepped in and adopted a law on *fiducie*, the use of security agents as trustees to receive and hold title to assigned receivables, which went into effect in October, 2007. This *fiducie* system does not involve use of a registry.

Effective March 23, 2006, a new Chapter IV was added to the French Code Civil on the subject of security. One important aspect of the amendment was the creation of a new, registrable floating lien on inventory called the *gage des stocks*. A *gage des stocks* must be registered with the clerk of the court at the location of the debtor’s headquarters or domicile within 15 days after execution of the security agreement (*acte constitutif*) or it is void.

The March 23, 2006 amendment also provided for a new, registrable security interest in movable property, such as equipment, called the *gage sans depossession* (“pledge without dispossession”). The *gage sans depossession* is registrable like a *nantissement* with a new registry of the *Tribunal de Commerce* at the location of the debtor. These registries were finally established in January 2007 pursuant to a decree of the Ministry of Justice issued on December 23, 2006. The *gage sans depossession* is intended to be more flexible than the *nantissement*, in that it can be used to take a security interest in less than substantially all the fixed assets of the debtor and can be perfected by registration.

“Infogreffe,” the website of the clerks/bailiffs of the *Tribunals de Commerce*, lists numerous types of filings, only some of which concern security interests such as *nantissements*. These include tax liens (*privileges du Tresor Public*), Social Security liens (meaning liens for medical services provided by the French socialized health care system), notices of bailment (*credit-bail*), vendor’s *privileges*, notices of “contract of location,” hotel, industrial and oil “warrants,” and several others besides *nantissements* and *gages*.

The French registration system for personal property security must be seen in context. While banks do take *nantissements* and *gages* to secure business loans, mortgages of real property (*hypotheques*) are usually preferred. Vendors on credit

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35 *Code Monetaire et Financier* Arts. L. 313-23 et seq.
39 A *greffe* is a court clerk’s office; however, the *greffiers* also perform tasks such as service of documents normally performed in the United States by the sheriff or bailiff.
usually rely on retention of title to the goods, which is valid without registration, rather than on registered security interests, and lenders may rely on fiduciary title arrangements rather than on registration, as a fiduciary transfer of title is effective in insolvency proceedings. The new fiducie law regarding assignments of receivables is consistent with this concept.

2. The Filing System: Functional Aspects

Even under the new system, filing is done in hard copy. Although the decree of the Ministry of Justice implementing the March 23, 2006 amendment contemplated an electronic system in which electronic signatures would be used (and made effective by French statute), it remains impossible to file online, though the system can be searched online (see http://www.infogreffe.fr/infogreffe/afficherGageSansDepossession.do).

To file a gage sans depossession or a nantissement de fonds de commerce, the secured party must submit two copies of a form (bordereau) along with the original security agreement (acte constitutif). The documents do not need to be notarized. The filing is commonly done by the creditor’s attorney. The bordereau must include the following:

1. For an individual debtor, the debtor’s full name, date and place of birth, domicile together with his RCS (business registry) identification number and the location of the clerk’s office where it is registered;
2. For a legal entity, its form and type, headquarters address, and RCS (business registry) identification number and the location of the clerk’s office where it is registered;
3. Date of the security agreement (acte constitutif);
4. Principal amount, maturity date, interest rate and whether there is a right of repossession in case of default (pacte comissioire)40;
5. For future advances, the “elements” that will make it possible to “determine” them;
6. Description of the collateral, including identifying marks or serial numbers if necessary, and the nature, quality and quantity of after-acquired collateral;
7. For companies of which a “part” is being pledged, the form and type of entity (e.g., of a corporate subsidiary), its headquarters, registration number, and its “nominal” (par?) value.

Each form is assigned a file number and one copy, with the file number and a certification that it has been filed, is sent to the filer.

The registrar reviews the bordereau for consistency with the underlying security agreement, and may reject the filing in case of inconsistency. Thus, once a document is filed, it becomes incontestable. This results in a slow indexing process and indexing delays.

Filings are valid for five years upon which they expire unless renewed. The clerk’s office also accepts amendments of filings, for which a form must be submitted in duplicate. A notation is made on the original bordereau that an amendment has been filed.

40 Nonjudicial enforcement of security interests was another innovation of the March 23, 2006 amendment of the Code Civil. However, the pacte comissioire is unenforceable if the debtor is insolvent.
Japan

1. The Filing System: Legal Framework

In Japan, the usual method of giving security for a debt is the "security transfer" (joto tanpo). There are two methods of perfecting a joto tanpo. The older method, pursuant to Civil Code §§182-184, is through constructive possession, called “transfer by declaration,” in which the debtor agrees in a formal declaration to hold the collateral as agent of the creditor. Transfer by declaration is generally effective against third parties without registration. However, with respect to receivables, under the Civil Code method of perfection, the declaration must either be notarized or served on the account debtor by special delivery mail, or the account debtor must sign an acknowledgment.41

The newer method, available for most types of assets since October 3, 2005, is registration with a centralized registry located in the Tokyo Registry Office in Nakano (a district of Tokyo) pursuant to a statute enacted as of that date and regulations issued by the Ministry of Justice pursuant to the statute.42 However, registration is only effective as to debtors that are "juridical" persons (i.e., not natural persons). Creditors can perfect in the assets of individual debtors, including sole proprietorships, only through transfer by declaration.

The new filing system is not limited to the registration of security transfers. Transfers of goods and other assets for other purposes may be registered as well, presumably including transfers by way of mergers and acquisitions.

Perfection by filing is available both with respect to tangible personal property (dosan), including inventory, and accounts receivable. Floating liens are permitted covering receivables and inventory. However, with respect to receivables, Ministry of Justice regulations require that the filing identify any known account debtors as of the filing date.

The two methods of perfection are not mutually exclusive, and typically creditors use both methods where both are available. A weakness of the filing system is that an earlier, unregistered transfer by declaration will defeat a joto tanpo perfected by registration.

2. The Filing System: Functional Aspects

The filing system at the Tokyo Registry Office is fully computerized. Filing requires a description of the collateral. For tangible personal property, the description

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41 Civil Code §467. Notarization or service on the account debtor is necessary to obtain a fixed priority date for the declaration. Since notarization was never an essential condition for perfection in receivables, the chamber of notaries did not oppose adoption of a registration regime, unlike some other countries such as Mexico.

42 The statute, entitled “Special Rules of the Civil Code Concerning the Perfection Requirements for Transfer of Receivables and Transfer of Goods,” despite its name, is an independent act that has not been codified and given official Civil Code section numbers. The centralized registry evidently is something new. Prior to late 2005, perfection by filing was available only as to receivables and had to be done at the local Commercial Registry at the location of the debtor, including any branch offices.
must either state the nature or character of the collateral, or its location (e.g., “all assets located at [address]”). Description by location has raised unsettled legal issues: e.g., what happens to the secured creditor’s perfected status if the collateral is moved to a different location? The filing also must state the number of assets covered.

There is no open access to the filing system to conduct searches. Rather, an interested creditor must make a request to the registry for a search. Any member of the public can request a summary certificate from the registry stating whether or not there are any filings against a particular debtor. However, to obtain more detailed information, including the creditor’s names and the type of tangible personal property or receivables covered by prior filings, one must qualify as either a party to the transfer covered by the filing, a creditor who attached or seized the collateral through judicial proceedings, or an employee of the debtor or a union of the debtor’s employees.

Thus, prospective creditors to whom the debtor has applied for credit cannot search the system directly except to obtain a summary certificate. If the summary certificate indicates a prior filing, the prospective creditor can require the debtor to obtain from the registry a detailed certificate giving the necessary detailed information but cannot obtain it directly.

During the first two months that the filing system was in effect, starting in October 2005, there were fewer than 50 such filings per month. In December 2005, however, there were 181 filings covering 14,386 assets. The volume of filings in receivables, which have a longer history, has been rising each year.

Filings commonly are out-sourced to solicitors (shiho-shoshi) or licensed independent paralegals referred to as “administrative scriveners” (gyosei-shoshi). Shiho-shoshi handle many kinds of matters in Japan from bankruptcies to divorces, and gyosei-shoshi also can handle routine non-litigation administrative matters.

Mexico

1. The Filing System: Legal Framework

The legal framework of Mexico’s filing system is found in the Ley General de Titulos y Operaciones de Credito (“General Law of Titles [to Property] and Credit Operations”) (“LGTOC”), in Codigo Comercial (“Commercial Code”) Articles 18 et seq. and 1414 et seq., and in the Reglamento del Registro Publico de Comercio (“Regulation on the Public Commercial Registry”) (“RRPC”). Relevant amendments to

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43 Solicitors, shiho-shoshi, are distinct from bengoshi, the Japanese term for lawyers. Like English solicitors, shiho-shoshi cannot litigate complex cases and have limited powers, but are required to have legal training and to pass an examination. However, the authorized powers of shiho-shoshi are expanding, so that now, for example, they are authorized to appear in court and can handle real estate transactions.

44 Although Gyosei-shoshi are paralegals, they are required to pass an examination and are authorized to render certain routine legal services.

45 Articles 18 et seq. specifically concern the commercial registry. Articles 1414 et seq. concern enforcement of security interests, which requires judicial intervention. Some of the other articles of the Commercial Code concern related proceedings, e.g., Articles 1362 et seq. which govern the right of third persons to assert competing interests in legal proceedings, such as proceedings to enforce security interests. Mexico also has a law validating electronic signatures that is part of the Commercial Code.
the LGTOC and the Commercial Code commonly referred to in English as the “Secured Transactions Law” and “Commercial Registry Law” were published in the Diario Oficial de la Federacion (similar to the Federal Register in the U.S.) (“D.O.”) on May 23 and 29, 2000 and June 13, 2003. The RRPC was published in the D.O. on October 24, 2003.

Two key forms of security in movable property in Mexico are the prenda sin transmision de posesion (non-possessory pledge), governed by LGTOC §§346-380, and the fideicomiso de garantia (guaranty trust), governed by LGTOC §§395-414. Collectively these are called garantias mobiliarias (“movable guaranties”), as in Spain.

LGTOC §376 requires that the acto (official document or contract) creating, modifying, extinguishing or “ceding” (assigning) a non-possessory pledge and any judicial resolution canceling such a pledge be filed with the Registro Publico de Comercio at the location of the debtor’s domicile. LGTOC §410 contains a similar requirement for a fideicomiso de garantia. However, the LGTOC does not address the effect of failing to file in either case.

Before registration, documents must be reviewed and approved by a licensed notary public (notario publico) or public commercial broker (corredor publico), unless the amount of the transaction is relatively small (under about $80,000 US). The notario or corredor publico acts as a fedatario, an agent of the government whose witnessing of the signatures and placement of his seal on a document gives “public faith” (fe publica) – legal validity - to the document and renders its validity incontestable for most purposes.

After it has been witnessed and sealed and before registration, the legal validity of the document initially is established only as between the parties to the document. However, once the fedatario, either a notario or corredor publico, has given legal validity to a document by witnessing the signatures and stamping it with the seal, it is the duty of the fedatario to register the document. Under Commercial Code Articles 27 and 29, registration fulfills the second role, establishing fe publica as to third parties and thereby establishing priority over future filings.

Institutional lenders may also obtain permission from the registry to submit documents electronically for filing, utilizing an electronic signature. However, in no other case may anyone but the authorized fedatarios access the registry for any purpose other than a search.

Any movable property (bienes muebles) can be the subject of a non-possessory pledge, and both movables and real estate (inmuebles) can be the subject of a guaranty trust. However, these are not the only security devices in Mexico. Mexico’s Commercial Code also provides for numerous other liens on specific types of property, for which no registration system exists. For instance, creditos de habilitacion (“enabling

46 The corredor publico in Mexico is somewhat analogous to a licensed real estate broker in the United States, except that his or her function includes business brokerage and appraisal business and he or she has authority from the government to certify legal documents. As in other civil law countries, the notario publico in Mexico is not merely a clerical person authorized to attest to the genuineness of signatures, but a lawyer with advanced training authorized to act as agent of the state in certifying the legal validity of contracts, deeds and other legal documents. For example, a notario publico is responsible in a real estate transaction for certifying the condition of title, to some extent taking the place of a title insurer. Both a corredor publico and a notario publico must post a bond and are regulated by national trade organizations that have quasi-governmental status.

47 RRPC Art. 32.
credits”) and creditos de avio (“supply credits”) are liens on materials that arise by virtue of the type and purpose of the financing arrangements between the parties regardless whether, in the parties’ contract, the debtor has specifically granted a security interest. Similarly, creditos refaccionarios (“repair credits”) are liens on machinery and equipment that arise by virtue of the type and purpose of financing without a specific contractual grant of a security interest by the debtor. None of these types of liens can be registered.

Secured transactions also are often couched in the form of hire-purchase agreements. Though the LGTOC requires that such agreements be registered, it doesn’t say where, an omission which fosters uncertainty for secured lenders and prospective purchasers of assets.

2. The Filing System: Functional Aspects

Mexico has attempted to integrate and digitize its filing systems through a project called SIGER (Sistema Integral de Registro). Filing is done in state registries called Registro Publico de la Propiedad y del Comercio – a combination of the Property Registry with the Registro Público de Comercio - which also serve as registries for real property transactions as well as personal matters such as court orders regarding paternity and guardianships, corporate filings such as commercial powers of attorney, incorporation documents (actos juridicos or matriculas) and bonds of commercial brokers (correderos publicos), and certified copies of orders entered by courts and administrative agencies. A directory of these state registries can be found at http://www.cabin.gob.mx/directorios/registros/registros_publicos.htm.

The registries are regulated and supervised at the federal level by the Ministry of Commerce and Industrial Development (Secretaria de Comercio y Fomento Industrial) through the General Directorate of Mercantile Norms (Dirección General de Normatividad Mercantil), located in Mexico City. Within that agency, the Directorate for Coordination of the Registro Public de Comercio (Dirección de Coordinación del Registro Público de Comercio) has immediate responsibility.

However, within the states there are also branch registries. For example, the State of Nuevo Leon, one of the most progressive states, the capital of which is the city of Monterrey, has a central state registry in Monterrey, but there are also six branch registries in other towns. Monterrey is a large, technologically advanced city and one of Mexico’s most prosperous commercial centers.

Registration of a non-possessory pledge must be done electronically, while other types of filings can be done electronically or in hard copy at the registry office. Under RRPC Articles 2 and 6, registration requires submittal of a pre-codified summary form along with either the actual document to be registered, if submitted in hard copy, or an electronic file containing the text, transmitted over the electronic signature of the notario or corredor publico. The form must contain the name and address of both the merchant debtor and the secured creditor, a “description” of the obligation secured and the “import” of the guaranty, a specific identification of the collateral (with the exception that if the merchant debtor is giving as collateral “all the movable goods that he uses for carrying out his preponderant activity,” a “generic” description will suffice, though the
RRPC does not specify what is meant by “generic”), and the expiration date of the guaranty.48

Registries are required to maintain an electronic folio for each commercial business, whether or not it is incorporated. If a merchant is incorporated, a folio is automatically created upon incorporation. If the merchant debtor in a secured transaction is an individual, before proceeding with its analysis of documents creating a prenda sin transmision de posesion or fideicomiso de garantia, the registry must determine whether a folio has been created for the debtor and if not, it must create a folio before proceeding further.

Upon receipt of documents for registration, the registry sends back to the notary or public commercial broker, or other submitting party, an acknowledgment, called a boleta de ingreso. The boleta contains a control number, the numbering of which corresponds to the chronological order in which documents were received and establishes their priority relative to other filings.49

Once received, the documents undergo an initial “analysis” by the registry. In the case of a non-possessory pledge submitted electronically by a fedatario, the acto or legal document creating the security interest has already been given fe publica as between the parties to the transaction upon review and approval by a notary or public commercial broker, so the only function of the registry’s analysis with respect to a non-possessory pledge is to ascertain whether the summary form contains the required information and whether the fee paid is correct.50 If so, the electronic documents are “captured” and “pre-inscribed” in the relevant folio.

However, in all other cases, the Commercial Code and RRPC contemplate that the registrar will conduct a substantive review and “qualification” of the contract documents, even though where documents have been submitted through a fedatario, i.e., a notary or public commercial broker, this is largely duplicative of the review already conducted by the notary or public commercial broker. The registrar is required to be a licensed attorney with at least two years’ experience in matters dealing with fe publica and registration.51

The registrar may reject a document if it is (a) an acto or contract not appropriate for recording, (b) contradicts information already on file in the registry, or (c) fails to contain, or to express with sufficient clarity, the essential data that the filing is required to contain.52 The registrar has four days after physical receipt of documents, or one business day after electronic receipt of documents, to notify the submitting party of a correctable defect or omission, and the submitting party then has five business days to correct the documents and preserve its priority date.53

Corrections require use of a separate standardized form. They are of two types: “material” errors and “conceptual” errors. Examples of the former include typographical errors, substitution of mistaken words, omission of necessary information, and errors in

48 RRPC Art. 31.
49 Commercial Code Art. 21bis(I).
50 See RRPC Art. 33(III) (as to non-possessory pledges, the registry’s analysis will “not determine the legal validity of the acto [legal document] for filing, but rather will be limited to review for whether the form presented contains the required data for filing and whether the tendered payment is correct”).
51 RRPC Art. 36.
52 Commercial Code Art. 31.
53 RRPC Art. 18, ¶1.
copying proper names and/or numbers from the acto, the document creating the security interest. Conceptual errors include alteration or variation in the contents because, in preparing the required form, the submitting party made a mistake in classifying the type of contract or other act it represented. Correction of material errors is a simple clerical process, but correcting a conceptual error requires consent of all parties to the transaction or a court order.

Under the auspices of SIGER, almost all of the state registries have agreed to interconnect their databases, with the critical exceptions of the registry for the Distrito Federal (Mexico City), which is barely functional and notoriously arbitrary and inefficient, and the registry for Baja California del Norte (Tijuana). At least a few can, in theory, be searched online, e.g., the database for the State of Jalisco (Guadalajara). However, in practice, interconnection remains theoretical for prospective lenders and purchasers that wish to conduct a search.

Spain

1. The Filing System: Legal Framework

The principal security interests that can be created in personal property in Spain are the chattel mortgage (hipoteca mobiliaria) and the non-possessory pledge (prenda sin desplazamiento). A chattel mortgage may be created as an encumbrance on: (i) an entire commercial enterprise (establecimiento mercantil), including the premises of the business and its facilities, its commercial signs, the lease and transfer rights of leases (derecho de traspaso), as well as inventory and machinery provided that they form part of the mortgaged business; (ii) vehicles; (iii) aircraft; (iv) industrial machinery; and (v) intellectual property rights, including trademarks, patents, copyrights, and inventions. A non-possessory pledge may be created as an encumbrance on the following: (i) agricultural business property such as a harvest, products of a business, its animals and tools; (ii) machines and other movable property, which may be identified by their particular characteristics, such as trademark, model, manufacture number, or other analogous characteristics, and in regard to which a chattel mortgage may not be established; (iii) inventory and raw materials that are located in a certain place, building or store; and (iv) works of art such as paintings, sculptures, and books. A chattel mortgage or non-possessory pledge cannot be created on any movable property until its price has been paid in full, unless it is created solely to secure payment of the deferred part of the purchase price.

Spain has three principal registries under the auspices of the Ministry of Justice: the Land Registry (Registro de Propiedades), the Mercantile Registry (Registro Mercantil, for registration of businesses and business entities), and the personal property registry, called Registro de Bienes Muebles (Movable Property Registry), established pursuant to Código Comercial (“Commercial Code”) art. 23 and the Royal Decree (Decreto Real) of December 3, 1999. These registries are decentralized, so much so that the single province of Madrid contains over 50 registry locations, including

54 Commercial Code Art. 32, ¶2.
55 Ibid.
56 RRPC Art. 19; Commercial Code Art. 32bis.
the Registro Central de Bienes Muebles (Central Registry of Movable property).\textsuperscript{57} Separate registries exist for the registration of corporate stock (Comision Nacional del Mercado de Valores, \url{www.cnmv.es}) and for licensing of insurance companies.

The Movable Property Registry includes several sections, one of which is called the Seccion de Garantias Reales ("Section of Real\textsuperscript{58} Guarantees") in which security "guarantees" (garantias), including hipotecas mobiliarias (chattel mortgages) and prendas sin desplazamiento (non-possessory pledges) in industrial and intellectual property, are registered. Other sections include Ships and Aircraft; Automobiles and Motor Vehicles; Industrial Machinery, Mercantile Establishments and Equipment; Other Registrable Goods; and the "Registry of General Conditions," comparable to the "general index" maintained by County Recorders in California in which judgments, tax liens and other encumbrances not created with respect to a specific asset are recorded.

Types of documents that may be filed in the registries include the following: installment sale contracts, leases of personal property including sale-leaseback transactions, chattel mortgages and non-possessory pledge deeds, ship mortgages, notices of attachment (embargo) and of the pendency of lawsuits with respect to movable property, sale-purchase contracts for movable property, contracts to make an inter vivos or testamentary (mortis causa) gift of movable property, and general contract conditions.

Registration of a chattel mortgage or non-possessory pledge has the effect of freezing the collateral in the hands of the debtor. Collateral cannot be sold or otherwise transferred without the consent of the creditors. Moreover, acceptance of a document for registration renders the document incontestable, as in the French system. As in France, the analysis required for acceptance of a document makes the registration process sluggish, though time limits apply (see below).

Pledges of shares and bank accounts do not require filing in the registry. These are perfected by recordation of the pledge on the books of the company and on the stock certificate (if any), in the case of shares, and by notice to the depositary bank in the case of a bank account.

Spain has no system for registering security assignments or sales of accounts receivable, which are not considered movable property. Security assignments and sales of receivables are accomplished either by indorsement of a bill of exchange, if the receivable is evidenced by one (as is common), or by a notarial deed. The use of receivables for financing is limited by the requirement that the notarial deed specify each receivable being transferred.

Conditional sale contracts of clearly identifiable tangible, movable, non-consumable goods payable in installments may be registered in the Movable Property Registry, as may equipment leases and other leases of movable property. Such contracts evidence retention of title (reserva de dominio) by the seller.

\textsuperscript{57} Locations can be viewed at \url{www.registradores.org}.

\textsuperscript{58} The word “real” in the civil law system of property refers to “real rights,” which are the types of property rights recognized under the numerus clausus of Roman law. Roman law standardized a handful of types of rights one can have in property. The UCC Article 9 security interest was not one of them. This is a source of great difficulty for commercial lawyers accustomed to the UCC system in communicating with lawyers trained in the civil law tradition of continental Europe and Latin America, who have difficulty understanding just what a “security interest” is.
2. The Filing System: Functional Aspects

The entire chattel mortgage or non-possessory pledge deed, not forms, must be submitted to the Movable Property Registry for filing. The documents must first be “legalized” by a notary. Notaries, called notarios, in the civil law system are attorneys with advanced training who are authorized by the state to review and certify the validity of legal documents. Notarization renders the document incontestable (in Spanish, it confers on the document certeza de operacion, certitude of legal validity).

Once notarized, the document is taken to the registry by the creditor or the creditor’s attorney or agent (not by the notary) for filing. The Registrar then must verify the authority and capacity of the person presenting the document for filing, and conducts an independent review of the propriety of the document for filing, which must be completed within 15 days. Once satisfied, the Registrar indexes the document and issues a certificate.

To be registrable, the chattel mortgage or pledge deed must include a specific description of the collateral. For example, if cattle are the subject of a non-possessory pledge, the notarized pledge deed must state the number of cattle and their location.

Commonly, a lien is taken by a creditor in the entire mercantile establishment, or in all of its industrial machinery and equipment. In such cases, as in the case of most chattel mortgages and non-possessory pledge deeds, registration must take place at the location of the business where the collateral is situated. Mortgages and pledges of interests in intellectual and industrial property are filed centrally in Madrid.

In general, registration of security interests in Spain is characterized by formality, lack of flexibility and relatively high costs. Notarial fees amount to about one percent of the first 601,000 euros of the secured debt, and .03% of the excess. In addition, stamp duty is normally levied at 0.5% of the secured debt, and registry fees amount to about one percent of the first 150,000 euros of secured debt, 0.3% of the excess up to about 601,000 and .02% of the excess over that amount. Thus, on a typical small business credit line, the debtor will pay 2-1/2 to 3 percent in fees just for notarization and registration, apart from fees charged by the lender.

In contrast to registration, searching the Movable Property Registry is relatively simple, and can be done online with a username and password.
CLASSIFICATION OF FOREIGN FILING SYSTEMS

Arnold S. Rosenberg

To promote one-stop filing and searching, enhance consistency and predictability, and lower the cost of credit, § 9-301(3) generally requires the secured party to perfect by filing in the filing office at the location of the debtor. If a debtor is incorporated or resides in a state of the United States, the secured party must file in the filing office of that state. However, under § 9-307(c), a debtor that resides, or maintains its sole place of business or its chief executive office, in a jurisdiction other than a state of the United States is located in that jurisdiction for purposes of Article 9 only if the laws of that jurisdiction require public notice of security interests in a filing, recording or registration system to establish priority over a subsequent lien creditor. § 9-307(c) establishes a three-part test:

(1) the debtor’s country must provide a filing, recording or registration system for perfecting non-possessory security interests in personal property;

(2) filing, recording or registering a security interest in that system must be “generally required” to establish priority over a lien creditor such as a bankruptcy trustee or levying judgment creditor (the “priority” test); and

(3) the information contained in that system must be “generally available” to interested parties such as prospective lenders and sellers (the “availability” test).

If the law of the debtor’s jurisdiction does not satisfy this three-part test, the debtor is deemed to be located in Washington, D.C. In such a case, the DC version of Article 9 will determine whether the secured party’s interest has been properly perfected and whether it has priority over other interests in the same collateral. For the most part, this means a financing statement against such a debtor should be filed in the District of Columbia.

Jurisdictions that have adopted the current or former version of Article 9 are deemed to satisfy this three-part test.1 However, other jurisdictions may satisfy it as well. The table below places non-U.S. jurisdictions into

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1. See § 9-307 comment 3.
four categories: (A) jurisdictions that clearly satisfy the three-part test of § 9-307(c); (B) jurisdictions with limited-purpose public filing, recording or registration systems that satisfy the three-part test, if at all, only as to those security interests for which filing is permitted; (C) “gray area” jurisdictions that do not clearly satisfy the three-part test even as to security interests for which filing is permitted; and (D) jurisdictions that clearly do not satisfy the three-part test.

If the debtor resides or maintains its sole place of business or chief executive office in a country listed in Category A, the secured party, to perfect its security interest, must comply with the laws of that country. Category A includes jurisdictions, such as most Canadian provinces, that have adopted some version of Article 9 or harmonized their laws with a version of Article 9. It also includes several countries that emerged from the former Soviet Union and that have enacted modern secured transactions laws drafted by legal experts from the United States and Canada or influenced by model legislation proposed by international organizations such as the Organization of American States and the European Bank for Reconstruction and Development.

Category B jurisdictions include many countries in continental Europe and Latin America. Perfection by filing in these jurisdictions is limited to certain types of debtors or creditors, certain types of collateral, or certain types of secured transactions. Some limit filings to licensed financial institutions; some to charges on the assets of corporate debtors; some authorize registration only of certain liens on industrial or agricultural property or liens on all assets of an enterprise.

Whether the law of Category B jurisdictions satisfies the three-part test remains unclear; it depends on how one construes the word “generally” in § 9-307(c). One view – the “Gestalt” approach – would categorize a country’s laws overall as either satisfying or failing the three-part test of § 9-307(c). If it fails the test, then filing in Washington, D.C. would generally be the only way to perfect, even as to those types of collateral,
transactions, or debtors for which a specialized public registry does exist under the laws of the foreign jurisdiction, and for which filing in that registry would be necessary to achieve priority over a bankruptcy trustee or judgment creditor.

The other way to construe § 9-307(c) uses a “limited-purpose” or “collateral-specific” approach.³ Under this approach, if filing in a limited-purpose filing system is “generally” required for the limited set of security interests covered by that system to achieve priority over the interest of a subsequent lien creditor, then the jurisdiction satisfies the three-part test of § 9-307(c), but only with respect to security interests that are capable of being registered in the limited-purpose filing system. Accordingly, in a single transaction, a secured party might have to file in the limited-purpose registry to perfect as to some security interests or collateral, while having to file in the District of Columbia to perfect as to others.

Category C jurisdictions include countries such as China and Argentina, whose laws or administration of those laws present serious issues about the availability of the information contained in registry records. They also include countries in which filing is required to achieve priority over a subsequent lien creditor only in narrow circumstances, so that it would be anomalous to say that filing is “generally” required for priority, and other countries in which the necessity for filing is unclear. When engaged in a secured transaction with a debtor in a Category C jurisdiction, counsel for the secured party should register a security interest in both the debtor’s country and in the District of Columbia. Although these countries likely would not satisfy the § 9-307(c) test in any event, proof of the facts supporting that conclusion might be difficult and costly to muster in case of a dispute.

Finally, Category D jurisdictions clearly fail the § 9-307(c) test, either because they do not have public registries in which notices of security interests may be filed, or because they do not recognize security interests

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³ See Arnold S. Rosenberg, Where to File Against Non-U.S. Debtors: Applying UCC § 9-307(c) [Rev] to Foreign Filing, Recording and Registration Systems, 39 U.C.C. L.J. 109, 132-35 (2006). Advocates of the limited-purpose or “collateral-specific” approach cite the phrase “with respect to the collateral” at the end of the penultimate sentence of §9-307(c) in support of their view, and construe “the collateral” as referring only to the specific collateral involved in a transaction.
at all. Such countries include several states in Europe that strictly adhere to the Napoleonic Code and other countries, such as Mexico, in which filing is a sufficient but unnecessary step due to the existence of alternative methods of perfecting the secured party’s interest without filing. For debtors located in a Category D jurisdiction, a filing in the District of Columbia would generally be sufficient to perfect a security interest in assets of the debtor for purposes of Article 9.

In using the table below, counsel should bear in mind several caveats:

1. Even in most Category D countries, and overwhelmingly in Category A, B and C countries, specialized registries exist for security interests in mobile goods such as motor vehicles, ships and aircraft, and in some cases, railroad rolling stock, and for patents, trademarks and copyrights. These specialized registries probably should be regarded as sui generis, although an argument can be made that they pull even Category D countries into Category B. Many, and perhaps most, countries also have registries in which security interests in real property and fixtures are recorded. Additionally, asset-specific rules may require perfection by means other than filing, similar to the Article 9 rules for perfection of security interests in deposit accounts as original collateral.4

2. If the issue of perfection is litigated in a foreign court, the foreign court would apply its own choice-of-law rules, not those of Article 9. A foreign debtor that becomes insolvent probably would file bankruptcy in its own country, not in the United States. The laws of that jurisdiction should be consulted to determine how best to protect the secured party’s interests in the event of the debtor’s insolvency.

Example: Debtor is a Canadian corporation with its chief executive office in Ontario, a Category A jurisdiction. Bank financed Debtor’s New York operations, taking a security interest in Debtor’s inventory located in Buffalo, New York. Bank perfected by registering its security interest in Ontario in accordance with §§ 9-301(3) and 9-307(c). A judgment creditor levied on Debtor’s inventory in Buffalo, and Debtor then filed bankruptcy in Ontario. A New York court, applying § 9-307(c), would hold that the Bank’s interest was properly perfected by registration in Ontario.

4. See § 9-312(b)(1).
However, § 5(1) of the Ontario Personal Property Security Act (“PPSA”), provides that the law of the situs of the collateral – here, New York - governs perfection of a security interest in goods. An Ontario bankruptcy court therefore would find Bank’s security interest unperfected because it failed to file a financing statement in New York. To ensure that Bank’s security interest was perfected regardless of the forum in which the issue of perfection is adjudicated, Bank should have filed both in Ontario and New York.

3. The § 9-307(c) test requires that filing be a necessary condition for priority over a lien creditor. It does not require that filing be a sufficient condition for priority. For example, a floating charge under English law must be registered for the floating charge to have priority over later-filed floating charges in the event of the debtor’s insolvency. However, a later-filed fixed charge, such as a chattel mortgage, will be accorded priority over a floating charge in the same asset. In addition, “lien creditors” as defined in Article 9 are not the only possible interests in competition with a security interest. Many jurisdictions recognize, in insolvency proceedings, “privileges” that resemble priority unsecured claims under Bankruptcy Code § 507(a) but are much more expansive. For example, personal injury claims, and especially claims for work-related injuries, have unlimited priority over security interests in several countries. Similarly, the claims of governmental agencies, and not only for taxes, have unlimited priority over security interests in many jurisdictions.

4. Requirements for perfection of security interests in other countries can radically differ from those of Article 9, and the differences may be material to the interests of the parties.

Example: Bank finances the Florida operations of Deudor S.A., a Spanish company maintaining its chief executive office in Madrid, Spain, a Category B jurisdiction. To perfect a security interest in Deudor’s inventory, equipment and accounts located in Florida, under § 9-307(c) Bank would have to register the entire loan agreement with the proper Moveable Property Registry in Spain. There are over 50 such registries in the province that includes Madrid alone. Moreover, before being submitted for registration, the loan agreement would have to be reviewed and approved by a Spanish notario, an attorney empowered by the government to
approve the legality of documents and render them incontestable. Once approved, the agreement then would be submitted for registration in Spain. Before it could be accepted and indexed in the registry, however, the registrar would have to verify the authority and capacity of the person submitting it and conduct an independent review of its propriety for filing, a step that could delay registration for another 15 days. If time is of the essence in the loan transaction, or if the parties are concerned about keeping the terms of the loan confidential, the delay and the disclosure of the terms through registration might cause the transaction to unravel. The expense of registration is another possible stumbling block, as notarial and registry fees alone can amount to 2.5 to 3 percent of the loan amount. Even though Spain’s registration system may satisfy the § 9-307(c) test, the cost, burden and delay involved in using the system might confound the expectations of parties accustomed to perfection by filing under Article 9.

5. The table below is intended as a starting point for research, not a one-stop resource. Relevant information about a country’s filing, recording or registration system can be difficult to obtain and even harder to comprehend and interpret. Laws concerning secured transactions are rapidly changing, and it is likely that some of the information used in compiling the table as of January, 2008 is already outdated. Users of the table below are cautioned to seek the advice of attorneys knowledgeable about the secured transactions laws of the jurisdiction at issue in a given transaction.

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## Classification of Foreign Filing Systems

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Notes to Chart

1. 1999 reform was based on Canadian PPSA; in bankruptcy, wage claims arising up to 12 months before bankruptcy and claims for debtor’s medical care or arising out of debtor’s illness or death have priority over registered security interests.

2. Limited purpose filing systems exist, but registries are seriously dysfunctional, and unregistered fiduciary transfer of title confers priority over lien creditors.

3. Pledge registry exists under 2004 law and is functional, but under Art. 6, registration system is limited to pledges of machinery and mobile goods.

4. English-type statutes at state level authorize registration of floating charges on company assets only; unregistered charges on assets of sole proprietorships and other unregistered security interests may also be enforceable in bankruptcy, but proposed PPSA clearly would satisfy § 9-307(c).

5. No public registration system; unregistered title retention recognized and excludes assets from bankruptcy estate.


7. English-type statute, floating charges commonly granted by companies; but administrative costs in bankruptcy have priority over charges regardless whether they benefitted the secured creditor and often result in no recovery from collateral.

8. English-type statute, floating charges common, but duty is placed on debtor to register a charge, on pain of a fine in case of non-registration, and unregistered charges remain enforceable against third parties.

9. No registry has been established and there is no law on registration, though Civil Code provisions copied from Russian Civil Code refer to a registry.

10. Unregistered purchase-money liens and “silent pledge” of receivables have priority in bankruptcy despite lack of registration; but enterprise charge on a business (gage de fonds de commerce or pand op de handelszaak) requires registration.
11. English-type statute, but registration is not essential to create an enforceable charge; unregistered charges and chattel mortgages have priority over subsequent lien creditors and in bankruptcy despite failure to register them.

12. Searches of registries permitted only at registrar’s discretion; no bankruptcy law exists; no law defines priorities between registered security interests and the interests of levying creditors.

13. 2005 reform was based on Canadian PPSA.

14. Industrial and agricultural pledges are registrable; fiduciary retention of title is recognized but must be registered; but in bankruptcy, wage and work-related injury claims, taxes and administrative expenses all have unlimited priority over registered security interests.

15. English-type statutes, floating charges are used, but registration of charges is voluntary and unregistered charges have priority over the liquidator and unsecured creditors in bankruptcy.

16. Registered non-possessory “special pledge” generally can be given only by non-consumer debtors in business assets, though the range is broad; registration confers priority in bankruptcy proceedings.

17. 2007 Law of Secured Transactions provides for priority of registered security interests from date of registration; Art. 13 gives security interests priority over bankruptcy officials and levying creditors unless they file before security interest is filed or perfected.

18. PPSA is based on 1972 version of Article 9; Quebec Civil Code harmonized with PPSA.

19. Unregistered fiduciary title transfers and some forms of unregistered non-possessory pledge have priority in bankruptcy; registries fragmented and poorly administered; but Capital Markets II reform law enacted in 2007 authorizes pledge of intangibles and may improve the registration and search process.

20. 2007 Enterprise Bankruptcy Law and Law on Property authorize registered floating liens in receivables and inventory, in addition to fixed chattel mortgages authorized by prior law, and give them priority in bankruptcy; but right to search registries is restricted to unspecified “interested parties”; in practice, local registrars have discretion whether to permit inspection.
21. No public registry; fiduciary title transfers enforceable in bankruptcy; claims for personal injuries, taxes, reimbursement of public health system expenses all have priority over secured claims in bankruptcy.

22. Excludes Northern Cyprus. English-type statute, floating charges used; but claims for work-related injuries, taxes, wages, fringe benefits, vacation pay and rents all have priority over registered charges in bankruptcy.

23. Registry maintained by Chamber of Notaries; former limitation of priority in bankruptcy to 70% of collateral was ended by 2007 Insolvency Law; however, floating liens are not recognized, and security interests cannot cover after-acquired property or replacements.

24. Act No. 560 of 24 June 2005 authorizes registered floating company charge on inventory, equipment, goodwill, after-acquired property, patents and trademarks, etc., and floating charges on receivables; but levying creditor has priority over registered floating company charge (but not registered floating charge on receivables) if holder notified within 3 days after levy; administrative expenses in insolvency proceedings up to 50,000 DKK have priority over floating company charge but not over floating charge on receivables.

25. Priority of registered nonpossessory pledges is limited to 70% of value of the collateral in bankruptcy.

26. Multiple types of security devices recognized, registries complex and balkanized, but modern secured transactions law based on OAS Model Law is under discussion.

27. Recent reforms may have significantly modernized secured transactions law and should be investigated.

28. Registry is computerized and functional; limited types of registered security interests authorized; further reform of secured transactions law to conform to OAS Model Law under discussion.

29. Floating charges in company property do not acquire fixed priority until insolvency or other event of “crystallization” but must be registered to have priority over unsecured creditors in bankruptcy; bill of sale of assets of an individual debtor may be registered but not widely used; however, retention of title by vendor under conditional sales contracts and charges on sole proprietorships are not registrable yet are enforced against unsecured creditors in bankruptcy.
30. Only a commercial pledge on all company assets is registrable; registration gives priority over unsecured claims in bankruptcy, but not over subsequent commercial pledges.

31. No legal framework yet exists for secured transactions.

32. Floating charges must be registered to have priority, may be created only by businesses.

33. Unregistered fiduciary title transfer is common and coexists with registered enterprise lien (nantissement de fonds de commerce) and other registered non-possessory security interests; both unregistered and registered interests of creditors in debtor’s assets prevail over unsecured claims in bankruptcy; security interests may be set aside as “disproportionate”; some wage and tax claims and administrative expenses have priority over security interests in bankruptcy.

34. Non-possessory charges on movables are registrable, but charges are paid pro rata in bankruptcy rather than by registration date.

35. Unregistered non-possessory pledge is effective against the administrator in insolvency proceedings; no public registry exists for pledges of most types of collateral; floating charges not recognized.

36. In 2007, became the first to adopt OAS Model Inter-American Law on Secured Transactions.

37. English-type statute; floating charges on company assets, chattel mortgages and bills of sale must be registered, but registration is not essential for other types of enforceable charges; many unregistered charges have priority over bankruptcy administrator and unsecured creditors in bankruptcy; registry poorly administered and not generally reliable.

38. However, proposed Secured Lending Law is based on OAS Model Law and would satisfy § 9-307(c) test.

39. Non-possessory pledges and floating charges must be registered, but priority in insolvency proceedings is limited to 50% of collateral value.

40. English-type system; floating charges on company assets must be registered, and have priority in bankruptcy; however, unregistered hypothecation agreements are common and enforceable in bankruptcy as well.
41. Fidusia security right can cover both tangibles and intangibles and requires registration; fidusia generally has priority in bankruptcy over unsecured creditors; however, priority over tax claims is questionable, and administrative expenses take priority over secured claims if the creditor fails to enforce its rights within two months after commencement of liquidation proceedings. Priority system has been characterized by the World Bank as “dysfunctional.”

42. Similar to English law, but unregistered retention of title by seller under conditional sale contracts is common and enforceable both against levying creditors and in bankruptcy; floating charges by companies must be registered, but not if given by sole proprietorships; claims for taxes, wages, fringe benefits, and work-related injuries have priority over registered floating charges in bankruptcy.

43. English-type statute; but in Israel, charges on assets of both companies and individuals must be registered, and registered charges have priority in bankruptcy; unregistered retention of title by seller may have priority in bankruptcy but is uncommon; however, true sale of receivables does not require registration.

44. Enterprise charge (privilegio) on company assets under Banking Law, Art. 46, must be registered and has priority in bankruptcy, but non-possessory notarized “irregular pledge” of movables (pegno irregulare) has priority in bankruptcy without registration.

45. Under 2005 amendments to the Perfection Law, security assignments (joto tanpo) and floating liens on receivables, inventory and other assets must be registered and are given priority over unsecured creditors in bankruptcy; however, fiduciary title transfer and pledges based on constructive possession coexist with new registration system; secured parties routinely use both methods to ensure priority.

46. Registration is mandatory for pledges of certain assets and confers priority in bankruptcy over most types of unsecured claims; but claims for “damage to health,” and wage, pension and alimony claims all take priority over registered pledges.

47. A virtual copy of the Albanian secured transactions law which in turn was based on the Canadian PPSA; electronic registration and searches available.

48. Pledge law authorizes non-possessory pledges, and registry exists, but registry is poorly administered and not reliable, and status of priority of registered pledges over unsecured claims in insolvency proceedings is unclear.
49. 2006 secured transactions law authorizes non-possessory security interests in business property, but registry is not cross-indexed, information not searchable for practical purposes.

50. Commercial pledges may be granted by companies and unincorporated business enterprises, must be registered, and have priority over unsecured claims in insolvency proceedings; noncommercial pledges are valid in insolvency proceedings without registration, as are purchase money security interests in consumer goods in the U.S.

51. Non-possessory pledges of both tangible and intangible assets are authorized and must be registered in a registry, which is fully computerized and searchable; registered pledges have priority in insolvency proceedings according to date of registration.

52. Pledges are registrable in a computerized registry; however, notarization is required and the notary has a duty to verify title to the pledged assets and the legal basis for the debt; registration process is slow, but priority dates from the date when the registration application was presented.

53. English-type statute, registered floating charges on company assets and certain other types of registered charges have priority in liquidation proceedings, but unregistered pledges with constructive delivery and conditional sales also are valid against a liquidator.

54. Non-possessory fixed and floating charges in most types of assets may be registered only by financial institutions; other creditors may take them only in motor vehicles, tools and professional equipment; registered charges have priority in bankruptcy, but a vendor’s unregistered interest in assets subject to retention of title is valid in bankruptcy as well.

55. Registries used mostly for consumer transactions such as auto loans; registrable security interests coexist with various types of unregistered purchase money security interests, both have priority in bankruptcy.

56. 2007 secured transactions law authorized registrable security interests that can be created by both business and consumer debtors, and established a computerized registry for all kinds of security interests. Because this law was adopted not long before this chapter was written, practitioners should take special care to verify that the registry is functioning properly and that priority of secured claims is honored in bankruptcy proceedings and execution of judgments.
57. Non-possessory pledges are registrable in registry maintained by chamber of notaries, but searches are reportedly unreliable because notaries use inconsistent numbering systems in indexing documents.

58. No public filing system for security interests; fiduciary title transfer not recognized under 1992 New Civil Code, but hire-purchase contracts are effective in insolvency proceedings without registration.

59. Based on Canadian PPSA.

60. Current law does not satisfy § 9-307(c) test, but a new law based on OAS Model Law is being discussed.

61. Sellers on hire-purchase contracts and some levying creditors take priority over registered floating charges.

62. Only business debtors; no enterprise liens, but floating charges may be created in operating assets, receivables and inventory; floating charges must be registered & have priority in bankruptcy.

63. English-type statute; registered floating charge, which can be created only by a company, is effective against liquidator up to value of collateral; charges on assets of an individual are not registered; registered deed of hypothecation only gives priority as to company assets.

64. Very limited types of collateral allowed, but registration grants priority in corporate assets outside Panama.

65. 2006 reform of secured transactions laws partially based on OAS Model Law, expanded range of permissible collateral and eligible secured parties, but did not eliminate many problems, including enforceability of unregistered security interests in bankruptcy.

66. Chattel mortgages are recognized and may be registered, though they cannot cover after-acquired property or future advances, but registries are notoriously unreliable and expensive; whether registries satisfy the availability test is questionable.

67. Registered Pledge Act was drafted by an American law professor in the early 1990’s; non-possessory registered pledges are widely used despite cumbersome registration process; collateral subject to registered pledge is excluded from the
bankruptcy estate, though unsecured claims for alimony and disability pensions may be paid before secured creditors.

68. No business charges of any kind are authorized.

69. Based on Canadian PPSA; but in bankruptcy, tax and other government claims have priority over registered charges.

70. No public registry for non-possessory pledges except vehicles and uncertificated investment securities; priority dates from of effective date of pledge agreement; a new secured transactions law may be under discussion.

71. Under 2004 Commercial Mortgage Regulation, a rahn (mortgage or pledge) may be created by constructive delivery of possession to creditor or a trustee via a deed of mortgage, and deed or a deposit receipt must be recorded; but law is silent regarding priority of a rahn and priorities are established arbitrarily in a given case by Board of Grievances.

72. Similar to English law, except that a vendor’s retention of title to property sold to a company must be registered as a charge on company assets.

73. 2005 reform established functioning registry for security interests in moveables, priority over lien creditors; interests in fixtures may still be problematic.

74. English-type law, floating charge on company assets must be registered and is given priority in insolvency proceedings.

75. Non-possessory pledges are authorized under 2003 pledge law and must be registered through a notary in an electronic registry maintained by Chamber of Notaries; assets subject to a registered pledge are separated from the “general bankruptcy estate” so it is not subject to claims of unsecured creditors.

76. Unlike English system, floating charges are not authorized; special notarial bond is a fixed charge only on specified assets and cannot float on changing collateral; notarial bond is accorded priority in bankruptcy.

77. Unregistered fiduciary title transfer, “yangdo tambo,” is effective in bankruptcy; public registries nonexistent or inadequate.

78. Chattel mortgage and non-possessory pledge must be registered and have priority over other creditors under 2003 insolvency law.
79. Enterprise mortgages and floating charges must be registered, but floating charges only have priority in insolvency proceedings as to 55% of the value of the collateral.

80. Retention of title by vendor must be registered, unlike other European countries; but only narrow categories of collateral are subject to pledge in favor of financial institutions, and registration does not affect priority, as registered and unregistered pledges both have priority in bankruptcy.

81. Modern registration system in place, but Chattel Mortgage Law does not cover inventory and accounts receivable; registration only permitted by Taiwanese creditors or trustees as to collateral in Taiwan.

82. Registration required for charges on inventory and for floating liens on an entire enterprise, but charges are not authorized on other assets, priority rules are unclear, and unsecured claims for wages and personal injuries have priority over secured claims.

83. However, a proposed Secured Transactions Act, currently pending cabinet and assembly approval, may comply with § 9-307(c).

84. Fiduciary title transfer and vendor’s retention of title are effective in bankruptcy; pledge of commercial undertaking, similar to French fonds de commerce, and pledge of receivables must be registered to have priority in bankruptcy, but registration is commonly avoided through fiduciary title transfer.

85. Charges on inventory and floating charges on the enterprise are authorized and registrable, but law is unclear on priority; wages, alimony and tax claims have priority over secured claims in bankruptcy.

86. 2004 secured transactions law is based on Article 9, and authorizes a uniform type of security interest in movables called an “encumbrance”; encumbrances may be created on both tangible and intangible assets and must be registered in a computerized registry; encumbrances rank according to filing date, and have priority over subsequent judgment creditors and in bankruptcy.

87. Industrial mortgages and industrial and agrarian pledges are authorized and may be registered, though only by certain financial institutional creditors; however, registries are poorly administered, unreliable, and effectively unsearchable due to lack of cross-indexing.
88. No public registration system for charges, though non-possessory charges are authorized; wages, taxes and public health system claims have priority over secured creditors in bankruptcy.

89. Registered chattel mortgages and non-possessory pledges limited to Venezuelan financial institutions and government creditors; guaranty trusts securing a commercial debt must be registered; unregistered title retention by seller excludes asset from bankruptcy estate.

90. 2007 law authorized registered floating pledges of inventory and receivables, and prior law authorized other pledges of movables; no consumer bankruptcy law exists, but Business Bankruptcy Law, Art. 38, excludes pledged property from bankruptcy estate.
HOMAGE TO DRACONIA:
ENFORCEMENT ISSUES TO CONSIDER BEFORE YOU RELY ON FOREIGN COLLATERAL

By
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In 1999, to introduce the world to Revised Article 9, the Chicago-Kent Law Review published a complete issue devoted to the topic. Neil Cohen of Brooklyn Law School and Ed Smith of Bingham Dana contributed to that issue a seminal article, *International Secured Transactions and Revised Article 9*, 74 Chi.-Kent L.Rev. 1191 (1999). To illustrate the issues raised for international secured transactions by Revised Article 9, Professor Cohen and Mr. Smith contrasted two fictional countries, Euphoria and Draconia. I am adapting those names to my purposes here, with Professor Cohen’s kind permission.

Euphoria, about which you will hear little, may be thought of as a place where the intellectual power of the Uniform Commercial Code is great. It has a filing system that complies with the dictates of 9-307(c), it considers that judgments obtained in a U.S. court satisfy its own notions of due process, it uses English as an official language and it accepts the choice of an American state’s law as a valid choice of law. Courts are readily open to foreigners, and judicial officials’ orders are readily respected and easily enforced. It understands concepts of after-acquired property, self-help repossession and a first-to-file priority system. Euphoria might be New Zealand or British Columbia.

Draconia, which this paper will explore at length, is its exact opposite. The term “security interest” does not readily translate into its official language, and it might have more than one such language. Its courts are a mystery to its own people and its magistrates’ rulings are widely ignored. Small formalities often outweigh significant property interests. If there is a filing system, it is unavailable to the public. Priorities can be based on ad hoc determinations. Needless to say, it is a brave and rare person who lends against property located in Draconia.

There may not be a real cognate to Draconia, but there are many real countries in the world that share characteristics with it. The purpose of this paper is to help practitioners to identify and plan for what may happen when they discover they are in fact trying to enforce a security interest in Draconia.

You Will Want More Than an Ounce of Prevention.

One of my best friends growing up had a dad who was a dentist. Thom used to show up at school wearing a t-shirt that read, “You Don’t Have to Floss All Your Teeth, Just the Ones You Want to Keep.” The same can be said for collateral located in a foreign jurisdiction. You don’t have to consult foreign counsel for all the collateral, just the part you want to rely on if the loan goes into default.
Truly, sometimes lenders will seek to do a less than adequate job of securing and perfecting against foreign collateral. Their goal is to fill in a box on a checklist, “Secure foreign collateral.” Or to emphasize a certain degree of seriousness about the borrower’s foreign operations, while not necessarily relying on the foreign collateral’s value in making the loan. These are, in appropriate circumstances, proper choices to have made. But if there is real collateral value in the foreign assets, particularly if they are being counted in a loan-to-value ratio, a lot more needs to be done.

The hiring of foreign counsel is critical to the task. But, more importantly, what is necessary is a skilled approach to the questioning of foreign counsel. It is easy to tell foreign counsel, “get me a perfected security interest in these assets.” It is much harder, before the fact, to learn enough about the foreign secured transaction regime and the foreign judicial system to know whether you have the equivalent of what you would have with a perfected security interest in U.S. assets under the Uniform Commercial Code.

A Little Learning: A Dangerous Thing

One doesn’t think of Canada as having Draconian implications. It’s a common law country, nine of ten provinces use English as an official language, and it’s well-known for having a Personal Property Security Act that is at least as modern and up-to-date as the UCC. Nonetheless, you can be tripped up by Canadian practices that aren’t identical to American practices.

When I was a very young associate (Ronald Reagan’s first term in office), I was asked to arrange to register a default judgment that had been obtained in Hawai’i in British Columbia. I failed. Why? Because jurisdiction under the default judgment had been obtained by a method of substituted service that was perfectly in accord with U.S. notions of due process, but was woefully short of what was required in British Columbia. Only an in-person service of process, we were told, would be respected by B.C. courts. Without it, our judgment was worthless.

Lesson: procedural steps you take in the U.S. can have very different consequences in other countries.

Learning: check with your foreign counsel not only about what you need to do in their country, but how what you do in the U.S. might impact it.

Sometime later, I was lead counsel on a large loan where the borrower had a significant subsidiary in Hong Kong, then still a British colony. One of our goals was to ensure that the cash of the Hong Kong subsidiary was tied up. We proposed to use a bancontrol agreement, a fairly standard arrangement, with a syndicate member who had a branch in Hong Kong. We consulted with Hong Kong counsel about this arrangement, and were given a response that demonstrated the different paths of evolution that British and American concepts of property have taken. Under British law, we were told, any rights of a bank that was owed money by a customer in that customer’s account effected an immediate offset of the account. So a bancontrol agreement with a bank that was a party to the loan agreement was essentially an
impossibility. Something we took for granted in the U.S. was completely unheard of in a system that had developed from the same roots.

Lesson: make no assumptions that even the most similar legal systems will allow the same procedures that you can do in the United States.

Learning: ask the most basic questions, and lead with a querulous tone. “In our country, we can do X in order to accomplish Y. Can you accomplish Y in your country, and how do you go about doing so?”

A few years later, a client wanted to take a security interest in inventory in Japan. We consulted Japanese counsel, who recommended a procedure that appointed a trustee to take title to the inventory. A year or so later, I was asked to file an affidavit with a Japanese criminal court attesting to the fact that our instructions were clear that the “trustee”, who had absconded with the proceeds of the inventory, had not been given title to keep the proceeds as his own property.

Lesson: Sometimes the workaround may not be worth the price.

Learning: Explore all the risks before deciding that “good enough” is in fact sufficient.

Fast forward to today. A few weeks ago, we were seeking to pledge the shares of a number of foreign subsidiaries for a domestic loan. All the shares would be held in the United States, so we were comfortable that U.S. law would apply when we issued an opinion letter. But then we learned that under Italian law, the share certificates were required to be presented in person at the shareholders’ meeting in order to constitute a voting quorum and for the payment of dividends.

Section 9-312(g)(2) allows for temporary perfection for 20 days but only for “presentation, collection, enforcement, renewal or registration of transfer.” We could not get comfortable that “having the shares available for quorum and dividend purposes” was within the scope of any of those terms, and the comments indicate that the list is intended to be exclusive. The alternative was to utilize the 8-301(a)(2) definition of “delivery” to have the shares delivered to someone on behalf of the secured party to present them at the shareholders’ meeting. But that would require the shares to be in someone’s hands in Italy, and what if Italian law had some special requirements that made the role of the person holding the shares in Italy incompatible with the provisions of 8-301(a)(2), and therefore the person was held not sufficiently an agent of the secured party to allow for continuation of perfection? That was a question we could not answer in a U.S. law opinion letter.

Lesson: There are quirks in foreign law (just as there are in the laws of U.S. jurisdictions) that only a local practitioner will know.

Learning: You may not be able to find them all, but you can get closer by asking the right questions.
Finding Draconian Culture Everywhere

Attached to these materials is an article by Anna Saeva, a Bulgarian attorney, raising a question an American practitioner might never consider: would Bulgarian courts enforce a security agreement in favor of a collateral agent or similar agent? The conclusion she reaches is, “maybe, maybe not.” Bulgaria is a country that has made great strides to modernize and harmonize its secured transaction laws since the days of Communist rule, but lingering issues remain.

What we will discover in our tour of the world is that the Draconian culture may be found in the most unlikely places and will lead to some surprising and interesting results.

Our tour book is the UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS, which may be found on the web at http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf. The UNCITRAL Guide is an invaluable resource to breaking down all the elements of secured transactions into their constituent pieces, which can then be measured against the real life laws of real nations.

Happily, someone has already done this for us. D. Campbell, ed., INTERNATIONAL SECURED TRANSACTIONS (2010) follows the UNCITRAL Guide’s format in a nation-by-nation discussion of secured transaction laws. Unfortunately, it does not cover as many countries as you might like; you will look in vain, for instance, for guidance on African secured transaction laws. However, IST, as we will call it, does a great job of breaking down the laws of the countries it does cover in ways that allow us to see some of the Draconian influences worldwide. For our purposes, it is not so much the good, Euphorian influences we are interested in; it is the permeation of Draconian culture. By seeing where Draconia has left its seeds, we can learn questions to ask for any country.

Argentinean Agnosticism. In the chapter on Argentina, the following sentence may be found: “Finally, in some cases the law does not provide how enforcement is to be carried out.” J.A. Kelly, “Argentina” in IST at ARG-22 (2010). This is, in essence, the core of the problem and Sr. Kelly is to be commended for his forthrightness. It is probably not just in Argentina that there are cases where the law is not sufficiently clear or the precedent sufficiently developed to provide an answer to every question a practitioner might have about how a security interest might be enforced.

Finnish Floating Charges. Finland has a modern secured transaction law, but it has a severe limitation on enforcement when the security interest is in the nature of a floating charge, which is how you would presumably finance inventory or accounts. “However, a floating charge does not allow the creditor to immediately sell the encumbered assets in the case of non-payment or insolvency, but the creditor must obtain a court order or submit a claim when the debtor’s assets are subject to bankruptcy proceedings.” Hedman Partners, “Finland” in IST at FIN-29 (2010).

As any practitioner knows, there is a huge difference between having nonjudicial remedies available to collect on accounts or to dispose of inventory, rather than proceeding through the
judicial system or a bankruptcy court. Speed and expense will diverge in unfavorable ways. Thus, one would think twice before giving much value to accounts or inventory in Finland.

**Brazilian Barriers.** In Draconia, the choice of law is always Draconian, but at least there is certainty to that effect. Similarly, there is certainty in Draconia that the parties cannot vary Draconian statutory law in their contracts, because those variations, of course, might allow the parties to agree contractually to provisions of U.S. law that they prefer to Draconian statutory rules.

Brazil has apparently not decided whether it is Draconian or not. Brazilian law contains a number of specific rules on default and in particular about when acceleration may be permitted in the event of default. However, it is simply not clear under Brazilian law whether these rules may be altered by contract. S.S. Silva, Jr., “Brazil” in IST at BRA-46 (2010).

**Jersey Uncertainty.** Far from Brazil, on the Isle of Jersey (which has its own laws), there is a statute that apparently provides an exclusive means of enforcement, through a power of sale. This doesn’t stop lawyers from drafting clauses that give other remedies. “Although the Security Interests (Jersey) Law 1983 does not specifically permit the parties to the security agreement to agree on alternative forms of enforcement or resolution other than the secured party’s power of sale, as a matter of practice, secured creditors will often incorporate alternative powers into the security agreement, although it is by no means certain that an exercise of such power would, if challenged by other creditors of the debtor in bankruptcy proceedings, be upheld by the court.” I. James & J. Rainer, “Jersey” in IST at JER-22 (2010).

American practitioners will not be surprised at this. Practice often precedes statutory authorization, and as often will proceed without challenge for awhile until someone finds it worthwhile to question the practice in court. If the courts do not find a way to agree to the new and valuable practice, then the next resort is often to the legislature. However, anyone utilizing the practice before it is approved is taking a risk, and any practitioner would be wise to exclude the practice from an opinion letter. One suspects the Jersey bar does not give enforceability opinions on the availability of remedies other than the power of sale.

**Bulgarian Barriers.** In Bulgaria, there is a significant barrier to the availability of judicial enforcement of a security interest: the requirement to pay, in advance, a fee of 2% of the amount sought to be enforced. G. Tzvetkov & L Lyubenov, “Bulgaria” in IST at BUL-42 (2010).

What I don’t know is if the fee is refunded if the amount recovered is less than the amount sought to be enforced; I rather suspect not.

This is not all that different, however, from the situation you might encounter with a title company. It will insure title only up to the fair market value of property, and will charge its fee on the amount insured. In a large loan to a company with a lot of real property, there might not be a ready way to divide the amount of the loan among all the properties (particularly if the main collateral is something else, like equipment or accounts), and sometimes it will make more sense to estimate the values conservatively to lower the premium rather than liberally, thereby paying the title company more when the risk of title problems may be considered low or the real loss in the event of loss of title is insignificant in light of the entire transaction.
In Bulgaria, one may well seek to pay the state less for its judicial services.

Just to complicate things, though, Bulgaria only allows self-help remedies where the collateral has a set market or exchange price. *Id.* at BUL-43. In other words, the state stands ready to help you, whether you want it to or not, and for a price.

**Chinese Cursoriness.** In the United States, it is often the case that execution on a judgment can take place over a long period of time. We’re all familiar with Ron Goldman’s father’s dogged pursuit of O.J. Simpson’s assets, wherever and whenever they may be found.

In China, however, there is a two-step process to execution. First, a judgment is obtained. Then an enforcement application must be given to the court. And there is a short and unusual statute of limitations on this application. If any of the parties to the case is a natural person, the statute of limitations is one year. If not, then it is only six months. J. Hou, C. Chow & Z. Zhao, “People’s Republic of China” in IST at CHI-38-39 (2010).

This teaches the lesson that it is critically important to know about, and monitor, post-judgment deadlines as well as pre-judgment ones.

**Greek Graciousness to Debtors.** Some collateral is more difficult to dispose of than others. And nothing makes it more difficult to find a buyer than the possibility of debtor redemption. Greece makes this particularly difficult by allowing debtors to redeem collateral literally up to the moment of sale. G. Bazinas & C.N. Klissouras, “Greece” is IST at GRE-31 (2010).

And just to make it even less easy to dispose of collateral, it is expressly forbidden for a debtor to agree to allow acceptance of collateral in full or partial satisfaction of the debt. *Id.* at GRE-32.

Allowing redemption such an open basis can seriously disrupt a secured party’s ability to find suitable bidders for collateral, which is probably not in the debtor’s best long-term interest either. Provisions like this, species of Draconian culture, make credit less available.

**Filipino Favoritism.** The Philippines seems to go Greece one better. There, the debtor is given the right to bid at any auction to sell its goods, and need only match, not beat, the best offer made at the auction. Moreover, the secured party is not permitted to bid at the auction unless there are other bidders. M.L.B. Tanawan, “The Philippines” in IST at PHI-21 (2010).

**Japanese Judicial Impossibilities.** Under Japanese law, in order to foreclose on collateral, “the creditor needs to obtain physical possession of the property or a consent of the holder of the property to the attachment by the court. Such requirement virtually precludes the enforcement of non-possessory security interests on movable properties . . . .” H. Kojima et. al, “Japan” in IST at JPN-26 (2010).

**Israeli Inquisitiveness.** In general, Israel may be thought of as being closer to Euphoria than Draconia. Israeli judicial precedent seems to indicate that it will accept a choice of foreign law in a security agreement, but it is very strict on the requirement that that foreign law be proven in

**Hungarian Guardianship.** In the U.S., we are used to our 9-609 rights to ensure that the collateral will be held safe, unused, consumed or spoiled by the debtor. In Hungary, they have the same concept, but with a very different set of rules. Essentially, the debtor gets to keep the collateral until sale. “However, if there is a danger that the debtor will not preserve the seized assets safely, the bailee may put the assets in a box or in a separate room and close it down.” C. Bán, “Hungary” in IST at HUN-30 (2010). I’m not sure I’d like to be lending against turbines in Hungary.

**Collection of Accounts: the Nirvana Experiment**

In their 1999 article, Professor Cohen and Mr. Smith are cautiously agnostic about the possibility of applying U.S. law to the collection of accounts where the account debtor is in a foreign country and not party to the security agreement. The exact adjective they used to describe the likelihood a Draconian court would apply Revised Article 9 to accounts between Draconian debtors and Draconian account debtors was “problematic” and they advised to “proceed with caution.” Cohen and Smith, 74 Kent-Chi.L.Rev. at 1225-26. From a practitioner’s standpoint, I considered that optimistic in 1999 and I still consider it so now.

While Professor Cohen and Mr. Smith focused on the enforceability of non-assignability rules in 9-406(d) and (f), I have also been concerned about what I consider to be the heart of 9-406, the last sentence of 9-406(a), “After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.” Putting the account debtor at risk of double payment if it ignores a notice might be considered pretty draconian, with a small “d,” under Draconian law.

To explore whether the Draconian courts might enforce that provision in a properly drafted security agreement that incorporates the law of a U.S. jurisdiction, let us look to the country just past Euphoria, which we will name Nirvana. In Nirvana, the secured parties rule the roost. They have a provision similar to 9-406, but it deletes important limitations in 9-406. In particular, they have no cognate to 9-406(b) and (c), the two provisions of 9-406 that protect the account debtor from confusion or making payments to multiple parties, or 9-406(g), which states that the right to have the account kept whole is one that the account debtor may not waive or vary.

Let us now take a proper security agreement that chooses the law of Nirvana and present it to a court in the United States, where both the debtor and account debtor are located and which is the sole jurisdiction where the account debtor does business. The secured party seeks to enforce an assignment of only half the account, does not reasonably identify the rights assigned, and has failed to provide proof that the assignment has been made, other to provide an order of a Nirvanan court (written in Nirvanan, a cross between Klingon and Quenya) that orders the account debtor to honor the assignment. I am confident that that U.S. court would declare that
the limitations in 9-406 to protect account debtors are fundamental public policies of its jurisdictions and choose not to enforce the assignment.

To be fair to Professor Cohen and Mr. Smith (particularly Professor Cohen’s graciousness in granting me permission to use the Draconia/Euphoria dichotomy here), they expressly recognize the likelihood that Draconia would similar consider its policies to be fundamental. Moreover, they were writing an academic paper about a statute that had not even come into force, while I am writing a practitioner’s guide. My point, however, is that from a practitioner’s standpoint, without pretty strong advice from local counsel to the contrary, one should assume that the only way to enforce an assignment of accounts in Draconia is by compliance with Draconian law.

CONCLUSION: WHAT WE LEARN IN DRACONIA

Draconia is a fictional place, but its policies, to a greater or lesser extent, can exist anywhere. The practitioner’s obligation is to root out Draconian policies and make them known to clients who are making business decisions valuing foreign assets in financing transactions.

To do so, it is important to bridge gaps of nomenclature, procedure, custom and practicality. Sometimes, this will lead to asking difficult questions. Asking a lawyer in a foreign country, “Can your courts be trusted to provide honest legal results?” can be embarrassing for both questioner and answerer. Some U.S. lawyers might balk at giving an unequivocal answer for their own courts.

My best advice to practitioners is to ask basic questions in a building block kind of way. “How are loan transactions typically secured in your country?” “What happens when a loan goes into default?” “Is it all right to have a collateral agent? Must there be an agent who is authorized to do business in your country?” “If one provision of a security agreement may not be enforced, may the rest of the agreement be enforced?”

It is extremely important to remember that no country has a monopoly on the correct way to run a regime of secured transactions. Respect for other country’s systems, customs and procedures is important, while at the same time understanding their differences from our own system so as to give proper advice to clients is paramount.
Is It "Secure" to Use a Security Trustee in Bulgaria?  
The Concepts of “Trust” and “Security Trustee”

It would be difficult to identify a universally accepted definition of “trust” and “security trustee” although these legal concepts appear to be well-developed in common law systems and are also acknowledged in a few civil law jurisdictions. Probably one of the most recognized and internationally supported definition of “trust” is provided by the Convention on the Law Applicable to Trusts and on their Recognition (the “Trusts Convention”). 1 It refers to the term “trust” as “the legal relationships created - inter vivos or on death - by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose”.

A trust is often used to save time and costs when creating security in finance deals. In such cases a security trustee is appointed to hold and manage the collateral under the finance transaction in its own name but for the benefit of a syndicate of creditors (i.e., to establish and perfect the collateral, to ensure its prompt maintenance, to undertake foreclosure in the event of default, etc.).

The “trust” relationships and the role of a security trustee are not expressly regulated by Bulgarian law. 2 Further, Bulgaria is not a party to the Trusts Convention. This lack of legal regulation poses important practical questions related to the use of a security trustee in finance transactions where Bulgarian law is relevant, which shall be briefly addressed below.

1. Security Trustee in Local Transactions

In general

In local financing where all elements of the transaction are related exclusively to the Bulgarian jurisdiction (e.g., the lenders and the debtor are local entities, the assets used as collateral are located and/or registered in Bulgaria, etc.), Bulgarian law usually governs all credit and security documents. According to Bulgarian conflict-of-law provisions in these cases the choice of a foreign law to govern the transaction would be possible but nevertheless all mandatory rules of the Bulgarian law would still be applicable. This rule makes the choice of a foreign governing law in such situations impractical.

In view of the above, may a group of local creditors appoint a security trustee to hold the collateral in trust for their benefit? If so, are there any legal risks in using this structure and is it possible that such risks can be sufficiently minimized?

Bulgarian law security interests

The most commonly used types of Bulgarian law-security interests are the mortgage and the pledge. In short:

- A mortgage is a security interest in a real estate or a ship granted by its owner (“mortgagor”) in favor of a mortgagee as a security for a debt. The mortgage takes effect upon registration in a public register and the possession of the property remains with the mortgagor.

- A pledge is a security interest traditionally established over movables and receivables, as the valid creation of a pledge over a movable requires the delivery of the possession of the asset to the pledgee or a person nominated by the pledgor and the pledgee (“possessory pledge”).

In addition, as of 1997,3 registered (non-possessory) pledges may also be established over movables (with the exception of aircraft and ships), receivables, aggregations of assets, securities, equity shares, industrial property rights and going concerns. The perfection of these pledges is effected by registration in a public register(s). As opposed to the traditional (possessory) pledges the setting up of a registered pledge does not require delivery of the possession of the asset to the creditor. Moreover, the pledgor may be entitled to dispose of the pledged assets in the normal course of business until foreclosure procedure is started.

The importance and use of the financial collateral4 - financial pledge or collateral assignment - also seems to be increasing in Bulgaria in recent years. A financial pledge is an arrangement where the collateral taker obtains a security interest in the relevant financial collateral (e.g., a monetary claim, shares, bonds, options, etc.), where the title in the collateral remains with the collateral provider. Collateral assignment involves title transfer of financial collateral to the collateral taker on the basis that it or equivalent assets will be
transferred back if and when the secured debts are discharged. Parties to the financial collateral arrangements may be certain entities, which are exhaustively listed in the law (such as public bodies, banks, insurance undertakings, investment brokers, financial institutions, etc.).

In all cases, upon foreclosure, the holder of the respective security interest holds a statutory determined priority for the satisfaction of the secured claims.

**Can a security trustee validly hold collateral in local financings?**

Generally, under Bulgarian law a mortgage and pledge are considered accessory to the secured claim, (*i.e.*, following its “destiny”). In particular, as per an express statutory rule5 the pledge and the mortgage follow the secured claim upon its assignment and are considered cancelled should the secured claim be extinguished. Furthermore, the effective statutory rules applying to a pledge and mortgage use the term “creditor” and “pledgee/mortgagee” interchangeably.

Based on the above specifics of the effective legal framework some legal practitioners in Bulgaria take the view that a security interest governed by Bulgarian law is valid **only if** the person receiving the security is at the same time the creditor. If such a view is accepted, this would mean that a Bulgarian law-security interest may only be validly granted separately to each creditor, but not to a security trustee who is not the creditor of the secured claims.6

The above legal conclusions are, however, not indisputable. Bulgarian law regulates various types of mandate relations.7 For example, the Commerce Act regulates the commission agreement as a type of a commercial transaction. In brief, the relevant statutory rules provide:

- under a commission agreement the commission agent shall undertake, for a commission, to perform in its own name but on behalf of the principal one or more transactions;
- the agent must provide an account of its acts to the principal and transfer to the principal the results from the transactions concluded with third parties in performance of the mandate;
- under a transaction concluded with a third party for performance of the mandate, rights and obligations shall arise for the commission agent. However, in the internal relationship between agent and principal, these rights shall be deemed rights of the principal. Furthermore, the rights acquired by the agent or granted thereto by the principal shall be deemed, with respect to the agent’s creditors, rights of the principal even before their transfer to the principal; and
- the principal may exercise the rights and may be compelled to meet the obligations vis-à-vis a third party only after their transfer by the agent to the principal.

The Trusts Convention rightly qualifies “trust” as a “unique legal institution”. No doubt that at present there is no arrangement under Bulgarian law which is identical to “trust”. Regardless of this, it seems that in the context of mandate regulations, on a contractual basis an agent should be able to validly hold a security interest in its own name on behalf of a creditor or on behalf of a number of creditors. This would not be inconsistent with the accessory nature of Bulgarian law-collateral, as the creditors shall be considered holders of the collateral both vis-à-vis the agent and the agent’s creditors even without a formal transfer of the security interest to the creditor(s).

As to the wording of Bulgarian law implying that the creditor and pledgee/mortgagee should be one and the same person – it must be construed more as a reflection of the typical situation in the Bulgarian financial market at the time the relevant legislation was enacted (*i.e.*, in 1951), rather than as a mandatory statutory requirement. A more recent Bulgarian law, the Financial Collateral Arrangements Act, which became in force as of August 2006, expressly acknowledges that financial collateral could be granted to a merchant, which acts on behalf of one or more persons, that includes bondholders or holders of other forms of securitized debt or any of the other regulated institutions expressly listed in the law as possible collateral takers (such as banks, financial institutions, etc.).

Despite the above strong legal arguments supporting the use of a security trustee in local transactions, the risks of successful challenges of the validity of Bulgarian law-collateral being held by a security trustee still do exist.
May a parallel debt clause minimize the above risks?

A possible way to minimize the above-referenced risks could be the creation of a parallel debt in favor of the security trustee equivalent to the secured claims of the lenders/other creditors. Thus, collateral held by the security trustee could secure also the parallel debt i.e., the collateral taker shall be deemed also to be the creditor. The borrower in this case will not be required to pay twice because any payment under the lenders’ claims will be deemed payment also under the parallel debt and vice-versa.

As mentioned above, in local transactions parallel debt arrangements would have to be governed by Bulgarian law (or at the very least by all of its mandatory rules). Bulgarian law requires the transactions to have a cause in order to be valid i.e., to have a direct legitimate purpose (e.g., to credit, donate, etc). Cause is presumed to be in place unless proved otherwise. It could be maintained that the cause of a parallel debt arrangement is to ensure valid security to the benefit of a changing group of creditors and, thus, argue that parallel debt is valid.

From a strict legal point of view the above interpretation certainly has its merits. However, parallel debt clauses are not sufficiently tested in practice in Bulgaria yet. Hence, attempts to challenge the validity of Bulgarian law governing parallel debt on the basis of absence of “cause” (and thus the collateral securing it) can not be dismissed.

Practical approach

Considering the existing legal uncertainties concerning the possible involvement of a security trustee in local transactions – when Bulgarian law governs all transaction documents (loan, security agreements, etc.) the security interests are usually held directly by all lenders but not by a security trustee. For the time being this conservative approach by local creditors seems to be justified. However, given the above mentioned provisions of the new Financial Collateral Arrangements Act using a security trustee to take financial collateral should not be too risky.

In any event there will be no obstacle for an agent as a direct representative of each of the lenders to be authorized to administer the collateral in their name.

2. Security Trustee in Cross-Border Transactions

In general

Financing arrangements with an international component have been quite common for Bulgaria during the last two decades. Such arrangements are usually governed by a foreign law. The choice of a foreign law to govern a cross-border transaction is a valid choice of law according to the Bulgarian conflict-of-law rules. Such choice will not prevent the application of the overriding mandatory rules of the Bulgarian law (such as e.g., regulatory, antitrust, tax provisions, etc.). Furthermore, the provisions of foreign law will not be applied where the results of their application are deemed to be contrary to Bulgarian public policy.

Can a security trustee validly hold security interests in cross-border financing?

Security interests governed by a foreign law

The use of a security trustee is not itself contradictory to Bulgarian public policy or in conflict with Bulgarian overriding mandatory rules. Thus, if a foreign law governs the security interests, a security trustee may validly hold such interests in trust to the extent the governing law permits, i.e., if such security interests are valid under the governing foreign law, then generally a Bulgarian court should recognize them.

Security interests governed by the Bulgarian law

There are situations where the master credit and security documents are governed by a foreign law (e.g., the laws of the State of New York, the laws of England, etc.) but a security interest is to be created and perfected as per the Bulgarian law. In this case the foreign law transaction documents often require a trustee acting in its own name but to the benefit of a syndicate of lenders and/or other secured parties to set up and hold the collateral under the transaction. Considering the specific Bulgarian legal concepts discussed above (as e.g., the accessory nature of the mortgage and pledge, etc.) the validity of Bulgarian law-collateral when taken by a security trustee might again be subject to challenges (see Section 1, third
subsection above). In the absence of relevant court practice the outcome of such potential challenges is not easily predicted.

May a parallel debt clause reduce the risks of the above challenges?

The answer to this question is definitely “yes” in cases where the parallel debt is governed by a foreign law and such law recognizes the validity of parallel debt clauses. In this case the Bulgarian legal concept of the need for “cause” of the transaction would not be applicable and generally the parallel debt structure should be recognized by the local courts. (Of course, the validity of such arrangements needs to be assessed on a case-by-case basis since the application of the specific contractual terms should not be in contradiction to Bulgarian public policy.)

On the other hand parallel debt governed by Bulgarian law would again involve higher risks for the secured parties (see Section 1, fourth subsection above).

Practical approach

In cross-border transactions with a Bulgarian component, security interests are often created and perfected in Bulgaria with the participation of a security trustee. The security trustee itself is typically organized under a foreign law, which is the recommended approach as no “trust” laws are enforced in Bulgaria. Should the Bulgarian law govern a security interest (e.g., a pledge over an aircraft with Bulgarian registration, etc.) often a parallel debt in favor of the security trustee is agreed to by the parties. Thus, the collateral held by the trustee secures the parallel debt or possibly both the claims of the lenders (other secured parties) and the parallel debt. The parallel debt is again governed by an appropriate foreign law.

The use of a parallel debt structure governed by a foreign law seems to be dependable as it substantially reduces the risks for the secured creditors to lose the local collateral.

In the case where this is a viable option (e.g., because the number of the creditors is limited) and/or where the core collateral is to be set up under Bulgarian law, foreign lenders may also decide to become direct parties to the Bulgarian law-security documents and, thus, ensure maximum protection for their interests.

Conclusion

On cross-border financings collateral in the name of a security trustee have been set up and successfully perfected in Bulgaria. However, considering certain traditional local concepts, rightly or not, secured creditors using a security trustee could be exposed to certain practical risks. There are contractual mechanisms to minimize these risks (e.g., the use of parallel debt clause governed by foreign law) but probably the best way to fully eliminate such risks would be if Bulgarian law is amended in the future to expressly recognize the role of the security trustee. Bulgaria joining the Trusts Convention would certainly also be a step in the right direction, and a step to be encouraged by both business players and legal practitioners.

1 The Convention became effective on 1 January 1992.

2 This is aside from certain perfunctory acknowledgements and references to the existence of “trust” in the tax legislation, in capital markets legislation and, arguably, in the law regulating financial collateral arrangements. For example, under the effective Public Offering of Securities Act “collective investment undertaking other than the closed end type” is defined to be “an investment undertaking or unit trust . . . (emphasis added).”

3 The year when the Special Pledges Act became enforceable.


5 Article 150 of the Obligations and Contracts Act.
6 Or least of all, not the creditor of all the secured claims.

7 Articles 280 – 292 of the Obligations and Contracts Act (mandate contract); Articles 32 – 42 of the Commerce Act (commercial agency); Articles 348-360 (commission agreement), etc.

8 Article 3, paragraph 1, item 16.

9 In the last case the lenders could rely not only on the parallel debt clause but also on the Bulgarian law-mandate regulations in order to defend the validity of the local collateral.

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