CROSS-BORDER

Part 1

Taking Security in Cross-Border Lending: (How Do You Know) the Steps to Take or Whose Law Is It Anyway?

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Navigating cross-border secured financing presents a complex challenge, where choice of law and conflict of law rules create an intricate maze. Unlike straightforward domestic transactions under the Uniform Commercial Code, international financing demands careful scrutiny of diverse jurisdictions' laws. David Morse of Otterbourg P.C. explores the practical steps lenders must take to secure rights over assets like inventory and receivables across multiple countries to ensure the lender has the benefit of such security. Part 2 of this article will appear in the November/December issue.

Choice of law rules and conflict of law rules in the realm of private international law are areas that lead into an intellectual maze of twist and turns, with results that are difficult to describe, difficult to analyze and difficult to understand. Yet, in a cross-border secured financing, the secured lender faces the very real, very practical dilemma of determining the correct steps to take to establish its rights to the accounts, inventory or other assets that are the security it may be relying on in making its loans. Those steps are dictated by the laws of the jurisdiction or jurisdictions that govern the secured lender's rights. While these issues apply to all categories of both tangible and intangible assets constituting personal property (also referred to as moveable assets), the focus below will be on inventory and trade receivables.

When structuring a secured financing of a business with assets and operations in a single jurisdiction, the matter is (relatively) straightforward. For a business with assets in the United States and customers in the United States, the Uniform Commercial Code (UCC), even with all 50-plus versions of it (one for each State, plus District of Columbia, Puerto Rico, U.S. Virgin Islands and others), provides a clear guide for the steps necessary to create a security interest as to most (albeit not all) categories of personal property, tangible and intangible, and then to establish the effectiveness of such security interest as to relevant third parties, including the priority of the security interest relative to the claims of other creditors and in an insolvency. But when structuring a secured financing of a business with assets and operations in multiple jurisdictions throughout the world, the secured lender will necessarily have to examine the laws of such jurisdictions to know what to do.

Taking Security: Security Rights in Tangible Moveable Assets

Let's start on the relatively easier path—tangible assets, particularly since it will provide some useful guidance in the subsequent discussion on intangible assets.

The Basics: Perfection and the Effect of Perfection Under the UCC

What if a U.S. based business has valuable assets at a location in Mexico? Perhaps the borrower under a secured credit facility is a retailer importing goods that come in through the port in Long Beach, California, get picked up at the port and taken to the facility of a "3PL" (third-party logistics company) in Juarez, Mexico? Since it is a U.S. business, for this purpose meaning a corporation or limited liability company organized under the laws of a State in the United States, the secured lender will start with the UCC to determine how to take its security. After all, in the event of insolvency, the U.S. business would most likely be in a Chapter 11 or Chapter 7 under the U.S. Bankruptcy Code in the United States.

Suppose the U.S.-based business is organized in Delaware. Since the company is organized under the laws of a State in the United States, the company is a "registered organization" under the UCC. For a registered organization, under UCC Section 9-307(e), the location of the company is its jurisdiction of organization. Under Section 9-301(a) of the UCC, subject to some significant exceptions provided in such section (more on that below), the law of the location of the company governs perfection, the effect of perfection or nonperfection and priority of a security interest. So, if the company is organized under the laws of the State of Delaware, it is "located" in Delaware and the secured party would comply with Delaware law. For the perfection of a security interest in assets like accounts and inventory, this means the filing of a UCC financing statement with the Delaware Department of State.

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But, in the example, this Delaware company has valuable inventory located in Mexico. Already, UCC readers are turning back to Section 9-301, the core provision for these matters, given away by its title: "Law Governing Perfection and Priority of Security Interests". Matters start to get a bit more complex because the UCC introduces an additional concept. In particular, just to focus on "nonpossessory security interests", Section 9-301(c) sends the secured party to the local law of the jurisdiction in which the goods are actually located to determine "the effect of perfection or nonperfection and the priority of a nonpossessory security interest in the collateral."

Under the UCC, the laws of two different countries are now quite relevant to the secured lender. For purposes of knowing the steps to take to perfect its security interest under the UCC, the secured lender will look to the requirements of Delaware law, but to establish the "effect of perfection or nonperfection and priority" as to the inventory in Mexico the secured lender will need to turn to the laws of Mexico. This distinction between "perfection" and its "effect" is the theoretical overlay of the UCC that at least as set out in the UCC is not found in the secured transactions laws of many countries.

As a secured party it may seem enough to have a "perfected" security interest. But isn't what really matters the "effect" of being perfected and the priority of the security interest? And, in any event, what does the "effect" of perfection (or nonperfection) really mean?

The comments to UCC Section 9-301(c) give a clear, simple example. A corporation organized under the laws of Illinois has equipment located in Pennsylvania. The secured party is perfected by filing a financing statement in Illinois, since that is where the borrower as a "registered organization" is "located" according to the UCC. But, the example goes on–if the law of the location of the borrower were to govern priority, then, for example, the priority of a judgment lien on goods located in Pennsylvania would be governed by Illinois law. Instead, the UCC says that it is the law of Pennsylvania, where the equipment is located, that will determine the priority of the secured party's rights to the equipment relative to the holder of a judgment lien.

Actually, the introduction of the local law where a tangible asset is located as the basis for determining the "effect" of perfection and the priority of a security interest leads to a legal concept commonly found in jurisdictions throughout the world: rex lei sitae. That is, "the law where property is situated." While legal Latin phrases are not as pervasively used in contemporary U.S. jurisprudence as in other legal traditions, this one provides a useful tool for connecting the UCC with a general principle that is at the core of most multi-jurisdictional secured financings.

The same principle illustrated in the comments to UCC Section 9-301(c) set out above with respect to the equipment of an Illinois company located in Pennsylvania may be used in the example of the inventory of the U.S. retailer located in Mexico (albeit inventory rather than equipment and located in Mexico instead of Pennsylvania). While the lender to the retailer with inventory in Mexico may be "perfected" by filing a financing statement in Delaware where the retailer is organized, under the UCC, the "effect of perfection or nonperfection and the priority" of the lender's rights to that inventory relative to other creditors is going to be subject to the laws of the jurisdiction where the inventory is located: Mexico. And that means that even under the UCC, the lender should take the steps necessary under Mexican law to establish the rights of the secured party to the inventory and the priority of such rights.

There is the practical matter of enforcement as well. While a Chapter 11 or Chapter 7 case under the U.S. Bankruptcy Code may be the more likely scenario for the retailer organized under the laws of Delaware, if the secured party were to want to enforce its rights in Mexico against the inventory located there, it would want to have rights that are based on the laws of Mexico.

As an aside, having the inventory at a location in Mexico operated and controlled by a third party (the "3PL" for example) may actually provide some distinct practical benefits to the secured lender, particularly in realizing on the inventory, if the secured lender has an agreement with the third party, as acknowledged and agreed to by the company, which provides that the third party will follow the instructions of the secured lender with respect to the inventory upon notice from the lender after a default.

Section 9-301(c) seems to provide the answer, at least under the UCC for United States law. It says that the "local law" of the jurisdiction in which the inventory is located governs the effect of perfection or nonperfection. The suggestion then is that the secured lender follow the "local law" intended to mean the laws of a jurisdiction other than its conflicts of law principles.

Beyond the UCC—A Civil Code Example

Take another example to illustrate the point, now not involving the UCC.

Suppose the borrower is a company organized under the laws of Switzerland and with its chief executive office in Zurich. While its chief executive office is in Zurich, the manufacturing facility where most of its inventory and equipment is located is in Germany. As to an asset like inventory, in general, Swiss law follows traditional civil code principles. Under Swiss law, in order for a secured party to establish its rights to an asset like inventory, the company must be "dispossessed" of the inventory—that is, as the term suggests, the company cannot have possession of its own inventory.

Historically, where there was no public registry for security rights to let a lender or other creditor know that assets are already pledged, one can see how taking assets out of the possession of the company would be an effective way to publicly show that the assets were subject to the claims of another creditor. Clearly an effective way of giving notice of a pledge. While perhaps effective as a means of notifying creditors that a company's assets were pledged to secure a debt, the effect of this rule makes reliance on inventory located in Switzerland quite challenging as a practical matter for obvious reasons. (Just to be more precise, there is a registry for retention of title rights in inventory in Switzerland, but in the example, the secured party's rights do not arise on the basis of retention of title.)

Germany, on the other hand, albeit from the same civil code tradition as Switzerland, has developed the concept of a "nonpossessory" security assignment or sicherungsabtretung. So, in this example, the fortunate lender and borrower may now obtain a security right to the inventory located in Germany owned by the Swiss company—because, Swiss law says to look to the law of the location of the property (rex lei sitae) for purposes of establishing the secured party's rights. The very same inventory, which if located in Switzerland, would not be available to the company to pledge to obtain additional credit (at least as a practical matter), is now in fact available to be pledged by compliance with

German law—which then satisfies the requirements of Swiss law where the company has its centre of main interests.

Beyond the UCC—A Common Law Example

Another example assuming tangible assets owned by a company organized in a jurisdiction outside of the United States but with assets located in the United States leads to a particular wrinkle in the UCC.

Take a company organized under the laws of Ontario, a province of Canada, which has enacted the Personal Property Security Act (PPSA), a very comfortable cousin of the UCC. The company has its chief executive office in Windsor, Ontario. But, the Ontario corporation has valuable inventory located in Michigan, say Detroit, right across the Ambassador Bridge from Windsor, Ontario.

The Ontario version of the PPSA has the standard rule discussed above which says that the secured lender should look to the laws of the location of the assets to determine how to perfect. The inventory being in Detroit means the secured lender turns to Michigan law for this purpose.

Under the UCC, to determine the laws that govern perfection, it is first necessary to determine where the owner of the security is "located." The UCC in Michigan (as in other States of the United States) has the general rules for determining where a company that is organized in a jurisdiction outside of the United States is "located." First, it says that for a company that is not organized under the laws of a State in the United States (that is, it is not a "registered organization" under the UCC), then under UCC Section 9-307(b), the company is deemed located in the jurisdiction of its place of business or if it has more than one, its chief executive office, but only if the special rule of Section 9-307(c) applies. The general rule of Section 9-307(b) with respect to using the location of the chief executive office only applies if the law of the jurisdiction in which the chief executive office is located:

> *"…generally requires information concerning the existence of a non-possessory security interest to be made generally available in a filing, recording, or registration system as a condition or result of the security interest having priority over the right of a lien creditor with respect to the collateral."*

If the law of the location of the chief executive office does not have a "filing, recording, or registration system" that discloses information about a security interest with such effect, then under Section 9-307(c) the company organized outside of the United States is deemed located in the District of Columbia. In other words, in order to use the location of the chief executive office of a company organized outside of the United States, the chief executive office will need to be in a jurisdiction with a lien filing system that satisfies the criteria specified in Section 9-307(c). Much has been written about the countries that may or may not have a lien filing system that satisfies these requirements.

The Ontario PPSA is, in fact, generally viewed as satisfying the requirement of having such a filing system (although the secured lender will still comply with the laws of the District of Columbia and file a financing statement there in order to avoid any question) and therefore, under the Michigan UCC, the Ontario organized company would be located in Ontario where its chief executive office is located using the general rule of Section 9-307(b). Ontario law says that to establish the secured party's rights it is necessary to comply with the laws of the location of the inventory, which is Michigan. Michigan law says to comply with the laws of the jurisdiction in which the chief executive office of the company is located: Ontario. (Sometimes referred to as a "renvoi" in private international law.) Now what?

Section 9-301(c) seems to provide the answer, at least under the UCC for United States law. It says that the "local law" of the jurisdiction in which the inventory is located governs the effect of perfection or nonperfection. The suggestion then is that the secured lender follow the "local law" intended to mean the laws of a jurisdiction other than its conflicts of law principles. Consequently, the secured lender files a financing statement in Michigan to address the inventory there—even though under Michigan law absent the reference back to Ontario law, a financing statement in Michigan would have no legal effect. While under Michigan law, the filing in Michigan has no effect—it does under Ontario law. And, of course, as a practical matter, the secured lender will file a PPSA financing statement in Ontario and the UCC financing statement in Michigan, so as to avoid any questions.

If the example involved a company organized under the laws of Germany which has no lien filing system, then the analysis for the inventory of the German company located in Michigan would be different. The rule of Section 9-307(c) as to the "location" of the company would be simply the District of Columbia and for purposes of the steps to take to perfect as to the inventory would involve the filing of a financing statement in the District of Columbia. This would also seem to address the requirements of German law, which on the general principle of rex lei sitae would apply Michigan law, which takes the secured lender to the laws of the District of Columbia, while the effect of perfection or nonperfection and the priority of the security interest would be governed by the laws of Michigan.

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