CROSS-BORDER

Part 2

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

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Taking Security: Security Rights in Intangible Assets

In the case of tangible personal property, the general principle to look to the laws of the location of the property captured in the phrase *lex rei sitae* provides some useful guidance for the secured lender on how to determine the steps that it will need to take in order to establish its security rights to such property. But what happens in the case of intangible property, where there is no such location? If the assets are the receivables owing to a company, whether arising from the sale of goods or services, or from other extensions of credit, or if the assets are a bank account or intellectual property, how does the secured lender determine the steps it should take to get rights to its security?

The Key Relevant Rights of the Secured Lender and "Third-Party Effectiveness"

In the case of an intangible asset like a receivable, such matters become quite complex, because it is not just a matter of the rights of the secured lender relative to the owner of the asset (and other creditors of the owner), but another key party: the obligor on the receivable (referred to as an "account debtor" in the UCC and simply a "debtor" in most jurisdictions outside of the United States).

As with tangible assets, the secured lender will want to comply with the law of the location of the grantor of the security right (whether in the form of a security interest, security assignment, pledge, charge or other form of security right) since the laws of such jurisdiction will likely be where most of its creditors are located and where most likely the company will be subject to an insolvency proceeding. This means for a company organized under the laws of a State in the United States, the secured lender will look to the UCC. For a company organized under the laws of England and Wales, or the Netherlands, or Germany, the secured lender will look to the steps needed to establish its rights to the receivables under the laws of England and Wales, the Netherlands or Germany, wherever the company is organized.

But whereas with tangible assets the secured lender needs to consider the laws of the location of the inventory or other tangible assets, with intangible assets like receivables, the secured lender will need to consider the laws where the obligor on those receivables is located.

The secured lender will need to identify the law that will establish the effectiveness of its rights as against other creditors and in the event of an insolvency (which under the UCC is through "perfection" of its security interest), but in addition must also identify the laws that will establish its rights relative to the obligor on the receivable. Addressing the rights of the secured lender as to both categories of parties is commonly referred to as a matter of "third-party effectiveness" of the secured lender's position.

With receivables as security, in addition to having a secured claim that will be recognized in the event of an insolvency or having priority over a subsequent consensual or non-consensual lien or pledge (like a judgment lien creditor or a taxing authority), the secured lender will also expect that:

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- after a default it may notify the obligor on the receivable of its rights and the obligor will be required to pay the secured lender in order to discharge the debt under the receivable, and if the obligor nonetheless pays the company after such notice, it will still be required to pay the secured lender,
- after a default, the secured lender has the right to enforce the right to payment if the obligor fails to make it, and
- the secured lender will have an effective security right notwithstanding any prohibitions on assignments (whether as security or outright) or prohibitions on the grant of security rights (commonly referred to as an "anti-assignment clause" or "ban on assignment") in the contract between the company that owns the receivable and the "debtor" obligated to make payment on it.

For a company based in the United States with customers located only in the United States, the UCC is relatively clear on each of these points.

- Section 9-406(a) of the UCC expressly provides that if the secured lender sends a notice to the obligor that meets certain basic conditions, the obligor must pay the secured lender, and if it pays the company instead must still pay the secured lender.
- Section 9-607 of the UCC expressly says that the secured lender may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the grantor of the security interest with respect to the obligation of the account debtor or other obligor.
- Section 9-406(d) of the UCC says that a term in a contract between the buyer and seller of goods and services that prohibits the grant of a security interest in, or an assignment of, the receivable arising under the contract (the "anti-assignment clause") is "ineffective".

Matters get a bit more complicated when dealing with other types of receivables that constitute "payment intangibles" as defined in the UCC and other types of contract rights even with respect to obligors in the United States but the principles are set out in the UCC.

What if the Obligor is Outside of the Grantor's Jurisdiction?

But, as with a U.S. based company with inventory in Mexico, what happens if the obligor on the receivable (the customer) is located outside of the United States? What law does the secured lender turn to in order to establish its right to get paid from the obligor?

Suppose a company based in New York, organized under the laws of the State of Delaware, is selling goods to a company in Germany and the lender to the New York-based company wants a security interest in the resulting receivables. First, to establish the rights of the secured lender in the event the borrower becomes subject to a case under Chapter 11 or Chapter 7 of the U.S. Bankruptcy Code and to establish the priority of the rights of the secured lender to the receivables under applicable laws in the United States as against other creditors of the New York based company, the secured lender will "perfect" its security interest in the receivables by complying with the laws of the location of the company, which under the UCC, since it is a "registered organization," will be Delaware. The same analysis applies to obtaining the rights in tangible assets.

But now, as to the secured lender's rights as against the obligor on the receivable, isn't it necessarily required to look to the laws of Germany? Will the laws of Germany find compliance with the steps set out in the UCC sufficient under German law? While alternatives may exist for obtaining a judgement in the United States against an account debtor that fails to pay, that does not get to the way the secured lender would prefer to realize on its receivables collateral.

The same question arises if a Dutch company is selling goods to a German company. As it complied with the UCC in the case of a U.S.-based company, the secured lender will comply with the laws of the Netherlands in the case of a Dutch company, to establish its rights to the receivables, but will that be sufficient if it notifies the German obligor to pay it or seeks to enforce payment in Germany against the obligor?

Here's the problem. While it may still be a matter of some discussion, it seems that the Rome I Regulation does not address "third-party effectiveness" at least to the extent of establishing the rights of the secured lender as against other creditors or in an insolvency and in any event is generally otherwise subject to different interpretations in various countries.

Different Jurisdictions, Different Answers

Different jurisdictions will have different rules as to the laws that the secured lender must satisfy to have the rights against the obligor located in that jurisdiction to get paid on receivables that it owes and have been pledged to the secured lender.

But perhaps even more significantly, different jurisdictions will have different rules for even establishing the effectiveness of the security right of the secured lender as against the grantor of the security right under the laws of the jurisdiction in which the grantor is located as discussed below.

Generally, there are three possibilities for laws that may be applicable either for purposes of enforcement of payment or other basic rights of the secured lender with respect to a receivable:

- the law of the location of the company granting the security right (that is, the grantor, pledgor or assignor),
- the law that governs the underlying contract between the seller of goods or services that gives rise to the receivable (the seller being the party granting the rights to payment to the secured lender as security) and the buyer of the goods or services (the obligor with respect to the receivable), in the case of trade receivables, or
- the law of the jurisdiction that governs the agreement between the secured lender and the grantor that gives rise to the secured lender's rights, whether a security agreement, a pledge agreement, a security assignment or assignment.

The first option is easy. The secured lender will always take security under the laws of the jurisdiction in which the owner of the assets is located as noted above. The second possibility is one that is more challenging but as discussed below, very important. For the secured lender looking at a cross-border financing involving intangible assets like receivables "the law governing the receivable" is a key concept and in some ways is the analog to the physical location of an asset like inventory under the principle of lex *rei sitae*. The law that governs

the contract between the seller of the goods or services owed the receivable, who is the grantor or assignor to the secured lender, and the buyer of those goods or services obligated to pay the receivable, can be of critical importance to the secured lender.

Take the EU for Example: Rome I Regulation

In the case of the German obligor, for example, since Germany is a member of the European Union (EU), the secured lender must necessarily look at the "Rome I Regulation" (just as would be the case for an obligor located in any of the other 27-member countries of the EU). The EU adopted the Rome I Regulation on June 17, 2008, as Regulation 593/2008 on the law applicable to contractual obligations (the successor to the Rome Convention on the law applicable to contractual obligations of 19 June 1980 (the Rome Convention)).

Article 14 of the Rome I Regulation has three parts.

- First, Section 1 says that the relationship between the secured party (or "assignee" as referred to the Regulation) and the owner of the receivable or other "claim" (referred to as the "assignor") that is granting the security right or making the assignment to the secured lender is governed by the law that applies to the security agreement or other "contract" between the "assignee" (the secured party) and the "assignor" (the grantor).
- Second, Section 2 says that the law governing the receivable that is subject to the security right governs (i) the relationship between the party owed the receivable (the grantor or "assignor") and the party obligated to pay the receivable (the account debtor or "debtor"), (ii) the assignability of the receivable or other claim, (iii) the conditions under which the security right can be "invoked" against the account debtor and (iv) whether the account debtor's obligations have been paid and satisfied (or as the Regulation says "discharged").
- Finally, Section 3 concludes that Article 14 applies to outright transfers of receivables or other claims, and transfers of receivables or other claims by way of security and pledges or other security rights over receivables and other claims.

Interpreting Rome I Regulation and Other Challenges

Here's the problem. While it may still be a matter of some discussion, it seems that the Rome I Regulation does not address "third-party effectiveness" at least to the extent of establishing the rights of the secured lender as against other creditors or in an insolvency and in any event is generally otherwise subject to different interpretations in various countries. In at least one case, the European Court of Justice has said that Article 14 of the Rome I Regulation does not apply to matters of third-party effectiveness. BGL BNP Paribas SA v. TeamBank AG Nurnberg (C-548/18 EU:C:2019;848; [2019] I.L.Pr. 39. But even beyond the matter of "third-party effectiveness", in some countries the effectiveness as against the owner of the receivable (whether a grantor, pledgor or assignor depending on the instrument used) may be based on the laws of a jurisdiction other than the laws in which the grantor or assignor is located.

On the basis of Section 1 of Article 14 of the Rome I Regulation, if a Dutch borrower pledges a receivable owing to it from a German obligor to a secured lender pursuant to a pledge agreement governed by Dutch law, under German law, such pledge agreement should be sufficient for purposes of the rights of the secured lender as between the secured lender and the owner of the receivable under German law (subject to general contract principles). And, in fact, this would be the case under German law, if "the law governing the receivable" is Dutch law.

German law has taken the view that the law governing the underlying contract between the buyer and seller that gives rise to the receivable governs both the effectiveness of the security assignment between the secured lender and the grantor of the security as well as the rights of the secured lender against other creditors and other third parties, and including the obligor on the receivable. On this basis, if a German company is selling goods to a Dutch company under a contract governed by Dutch law, then a German law governed security assignment would not necessarily be sufficient to establish the secured lender's rights, even aside from matters of third-party effectiveness. Instead, German law would require compliance with Dutch law, since Dutch law governs the receivable. Irish law is similar. In Ireland, the grant of a charge by an Irish company on a receivable governed by Irish law would be sufficient under Irish law, but it would likely not be effective if the receivable were governed by German law, even for purposes of such charge under Irish law.

By contrast, in the Netherlands, under Dutch law the applicable law for purposes of both the effectiveness of the security right against the pledgor of the receivable and the effectiveness against other creditors and an insolvency administrator is the law which governs the pledge agreement -- taking the principle in Section 1 of the Rome I Regulation and applying it not only to the choice of law in the pledge agreement as between the secured lender and the grantor of the security right (or pledgor), but also to the effectiveness against other third parties. If a Dutch company becomes subject to an insolvency proceeding in the Netherlands a pledge of the receivables that satisfies the requirements of Dutch law will be recognized in such proceeding regardless of where the obligor on the receivables is located or the law governing the receivable.

English law would take a similar view (and at the end of the "transition period" under the applicable withdrawal agreements between the U.K. and the EU, and corresponding legislation, which occurred on December 31, 2020, Rome I was converted into UK law as retained EU law, although amended by UK legislation).

Under Article 87 para.3 of the Belgian Code of Private International Law, it is the law of the country where the pledgor or assignor of the receivable to the secured lender has its habitual residence (*residence habituelle*) at the time of the grant of the security right that applies to the effectiveness of the secured lender's rights to the receivable as against third parties. To the extent that the Luxembourg Securitisation Act 2004 may be applicable it also provides that the law of the jurisdiction of the location of the "assignor" governs the effectiveness of the assignment as against third parties.

Ultimately, the significance of these issues in any given transaction may be reduced if the owner of the receivables is selling its goods or services under contracts with its customers governed by the laws of its own jurisdiction. If the German based assignor of the receivables is selling its product to the Dutch company on terms and conditions governed by German law, then the taking of a security assignment governed by German law will be sufficient. Or if the Dutch company is selling goods or services to the German company under contracts governed by Dutch law, then under German law this should be sufficient.

The secured lender may also consider the likelihood that an insolvency proceeding of its borrower or guarantor will be in a jurisdiction where there is an insolvency official that will act for the company in pursuing the payment of the receivables, in which case, the secured lender's rights will not need to be considered in the jurisdiction of the location of the obligor on the receivables.

The EU has attempted to address these differing views with the publication on March 12, 2018, of a Proposal for a Regulation to govern the law applicable to the third-party effects of assignment of claims (the "EU Assignment Regulation"). On February 13, 2019, the Presidency of the Council of the European Union prepared a revised version and on June 7, 2021, the EU approved a mandate for negotiations.

The Effectiveness of "Anti-Assignment Clauses"

Section 2 of Article 14 says that it is the law of the contract between buyer and seller that determines the assignability of the receivable (which would seem to cover the enforceability of an "anti-assignment clause", or "ban on assignment"). On this basis, the secured lender must look to "the law governing the receivable" to determine whether any anti-assignment clause that appears in such contract is enforceable. So, for example, if New York law was the law governing the contract between buyer and seller, then it would be clear that such a clause is "ineffective" under the New York UCC. But, if a Dutch company is selling goods to a German company, under a contract governed by Dutch law, what would be the outcome? Under Dutch law, such a clause would be effective and therefore the secured lender would not get a valid pledge of the receivable.

If the Dutch company were selling goods to a German company under a German law governed contract, the issue would be how German law views such a limitation or prohibition. In that case, Section 354a of the German Commercial Code (*Handelsgesetzbuch – HGB*) provides that in the case of a transaction between "merchants" such a clause is not enforceable (although such prohibitions may affect whether a payment by the account debtor to the grantor (or "assignor") after notice to the account debtor of the assignment of the receivable discharges the account debtor from its obligations under the receivables, as well as the rights of the secured lender being subject to any amendments to the underlying contract and other issues).

Interestingly, as to the effectiveness of anti-assignment clauses in the underlying contract between the seller and buyer, comment 3 to UCC Section 9-401 says Article 9 of the UCC "does not provide a specific answer to the question of which State's law applies to the restriction on assignment".

Proposed Legislative Solutions

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February 13, 2019, the Presidency of the Council of the European Union prepared a revised version and on June 7, 2021, the EU approved a mandate for negotiations. As of December 2023, according to a report from the European Parliament, "interinstitutional trilogue negotiations are ongoing".

The general principle under the proposed EU Assignment Regulation for determining the law that governs the establishment of the rights of the secured lender is the law of the "habitual residence" of the "assignor" (i.e. grantor or pledgor), with different rules for bank accounts and securitizations and certain other specific categories of transactions. At this point, it seems that the enactment of the EU Assignment Regulation is very much an open question having encountered resistance from different constituents.

The United Nations Commission on International Trade Law (UNCITRAL) has prepared the United National Convention on the Assignment of Receivables in International Trade and Factoring of December 12, 2001, which also establishes conflict of law rules. The general rule there as well is that the jurisdiction in which the assignor is located governs the priority of the rights of an assignee in the assigned receivable. Although signed by the United States and three other countries, it has not come into force which requires action by five countries.

There does not appear to be any imminent legislative solution to help the secured lender in its quest for greater certainty and simplicity in knowing how to establish its rights to security.

Consequences for the Secured Lender

Taking security in a cross-border financing involves extra steps not required for a purely domestic financing. These additional steps include both diligence and additional security documents governed by laws of different jurisdictions.

In the case of a tangible asset like inventory, it may require security documents and other steps required to comply with the laws of the location of the inventory. In the case of an intangible asset like receivables, notwithstanding the various interpretations and ongoing controversies around the Rome I Regulation, and for purposes of jurisdictions outside of the U.S., the U.K. and the EU, given the significance of both the laws of the location of the "assignor" (the grantor) and the law governing the underlying contract between the buyer and seller in the case of trade and similar receivables, a critical part of the diligence of the secured lender will often be to review at least the major contracts of its borrower or other grantor of the security right to see the laws that govern such contracts.

This, of course, presents a number of practical issues depending on the nature of the company's business. A company may have a few large contracts with major customers or dozens or more smaller contracts. It may have "standard terms and conditions" that generally apply to most of its sales or may have specifically negotiated contracts with customers. There may be just a purchase order or a purchase order issued by the customer (the account debtor) and an invoice issued by the seller (the grantor or assignor; the owner of the receivable). And there may be circumstances where no governing law is stated. The secured lender will have to make decisions as to how it wants to approach these circumstances as a practical matter.

In addition to the review of customer contracts, financings based on receivables may require determining whether such contracts include some version of an "anti-assignment clause" and then an analysis of the scope of such "anti-assignment clauses" under the law governing those contracts, as well as additional security documents in different jurisdictions.

Taking security in a cross-border financing requires a broad sense of how to determine the laws that need to be addressed so that the secured lender understands the scope of the rights that it has to its security.

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