Applying the Rev. §9-307(c) "Equivalence Test" to Foreign Filing Systems

By:
Prof. Arnold S. Rosenberg[1]
Thomas Jefferson School of Law
arosenberg@tjsl.edu

Introduction

Increasingly, American lenders and sellers are extending secured credit to debtors located in non-U.S. jurisdictions. If the collateral is located in the U.S., or if there is otherwise a possibility that U.S. law regarding perfection might be applied in case of a dispute, lenders and sellers need to determine which jurisdiction's laws – the Uniform Commercial Code ("UCC") or the laws of the non-U.S. jurisdiction – will govern perfection.

Under the "debtor location" rule of Rev. §9-301, UCC, which became effective in most states on July 1, 2001, the laws of the jurisdiction in which the debtor is located govern perfection of security interests in personal property. The debtor is located in a jurisdiction if the debtor is an individual with his or her principal residence there, or if the debtor is an organization with its chief executive office in the jurisdiction.

Thus, for example, if Bank of America were to make a business loan to a corporation headquartered in Ontario secured by the inventory, equipment and accounts receivable of its operations in the United States, Ontario law would govern perfection of Bank of America's security interest. Ontario has a Personal Property Security Act resembling pre-Revision Article 9 of the UCC, so to achieve priority over competing secured creditors, Bank of America would have to file a financing statement in accordance with Ontario law.

However, what if the debtor's country has no system for perfecting security interests, or has a system radically different from the American centralized filing systems, Rev. §9-307(c) establishes an equivalence test? If the laws of the debtor's country are not substantially equivalent to the Rev. Article 9 filing system, as measured by the criteria set forth in §9-307(c), the debtor is deemed to be located in the District of Columbia. The impact of non-equivalence is that the secured party is excused from compliance with non-U.S. law and may perfect under the laws of the District of Columbia.

Rev. §9-307(c) establishes the following criterion for determining equivalence: a foreign filing, recording or registration is equivalent to Rev. Article 9 if it "generally requires information concerning the existence of a

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[1] Prof. Rosenberg is a 1976 graduate of Harvard Law School and is Co-Chair of the UCC Committee of the State Bar of California Section on Business Law ("UCC Committee'). Prof. Rosenberg also chairs the Foreign Filing Systems Subcommittee of the UCC Committee. He formerly was a partner in the law firm of Bancroft, Avery & McAlister, San Francisco and served as General Counsel of California Pacific Bank. The views expressed in this article are entirely his own and do not necessarily reflect those of the UCC Committee or the ABA.

nonpossessory security interest to be made generally available in a filing, recording, or registration system as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral."

According to Official Comment 3, the purpose of Rev. §9-307(c) is to obviate the need to comply with foreign laws that "affor[d] no public notice of security interests." However, Rev. §9-307(c) fails to accomplish that end, and instead routinely results in a multiplicity of efforts to perfect security interests under both foreign and D.C. law whenever a debtor is located in a foreign country. In its present form, Rev. §9-307(c) often yields absurd results, creates pointless and costly hurdles for lenders and sellers, and impedes the smooth functioning of international credit markets and the orderly and timely consummation of cross-border transactions.

The State Bar of California Business Law Section UCC Committee is preparing a report on non-U.S. systems for filing, recording and registering security interests in personal property. The report is expected to provide information about the status of filing, recording and registration systems in several foreign jurisdictions, and may attempt to identify those countries that at the current time, clearly do not satisfy the "equivalence test," those that clearly do satisfy it, and those that occupy a gray area with respect to the application of Rev. §9-307(c). The report also may recommend changes in Rev. §9-307(c).

However, neither this article, nor the State Bar of California report in process, is intended as an opinion regarding the safety or advisability of extending secured credit to debtors located in any particular country, nor that a secured party can safely achieve priority by registering its interest in the collateral under foreign or Washington, D.C. law. Several caveats must be borne in mind by commercial lawyers in evaluating information about foreign filing, recording and registration systems.

First, a registration system may exist on paper but not be satisfactorily implemented. The state of implementation of a registration system can change over time. Second, if collateral is situated in the foreign country, and enforcement action becomes necessary, it cannot be assumed that a foreign court would recognize the validity or priority of a lien created under American law and perfected by filing in Washington, D.C.

Third, foreign law may not recognize security interests in the type of collateral, or in favor of the type of secured party, at issue in a particular case. Fourth, contractual choice of law clauses may or may not be given effect to alter the law that otherwise would govern perfection of security interests. Different foreign jurisdictions take divergent approaches to the effectiveness of choice of law clauses with respect to perfection.

Types of Registration Laws

Foreign laws regarding filing, recording or registration of security interests

tend to fall into four categories: Article 9-type statutes, the Continental European model, the English model, and the Latin American model. Many nations' laws, however, represent variants of these models or are idiosyncratic.

Article 9-type statutes. First, some countries clearly maintain filing, recording or registration systems that satisfy the first test of Rev. §9-307(c) in that they generally make available information concerning the existence of a non-possessory security interest in collateral. A few countries – Canada and New Zealand in particular – have independently chosen to enact Article 9-type statutes. Many countries of Eastern Europe and the former Soviet Union, such as Albania, Bosnia, Romania and Kazakhstan, have enacted Article 9-type statutes at the urging of the European Bank for Reconstruction and Development ("EBRD") and the World Bank. Some Asian countries, too, such as Indonesia and Taiwan, possess registration systems that bear some resemblance to Article 9; but in Taiwan and certain other Asian countries the application of foreign exchange and lender licensing laws make it difficult or impossible for foreign secured parties to use the registration system. In some countries of Eastern Europe and Central Asia, obtaining access to records kept in registration offices can be problematic due to arbitrary exercise of discretion by local bureaucrats or corruption.

The Continental European model. Second, many civil law countries clearly fall short of the requirements of Rev. §9-307(c). Such countries include Austria, Germany and the Netherlands, among many others. They maintain no system for registering security interests in personal property, with limited exceptions for assets titled under special laws and treaties such as ships and patents. In these countries, retention of title and fiduciary transfer of title are typically the methods by which sellers and lenders attempt to secure payment.

Title retention and fiduciary title arrangements prevail in most civilian jurisdictions, particularly in Western and Central Europe, both for doctrinal reasons and the lack of non-judicial enforcement procedures (and the inefficiency of judicial procedures) available to secured parties in case of default.[2] Such arrangements under UCC §2-505 would be limited to retention of a purchase money security interest in goods sold. Unlike the UCC, title retention and fiduciary title arrangements are almost universally upheld in Western and Central Europe against an insolvency trustee, with the exception of Luxembourg, on the theory that the collateral is property of the lender or seller rather than an asset of the bankruptcy estate. Apart from Switzerland, few European countries have a system of filing, recording or registration to publicize title retention and fiduciary title arrangements. It is left to the diligence of a lender to inquire whether the prospective borrower has fully paid the purchase price of any personal property offered as collateral, or repaid any loans that were the subject of a fiduciary title arrangement, and thereby acquired clear title to those assets.

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[2] *See generally* J. Michael Milo, "Retention of Title in European Business Transactions," 43 Washburn L.J. 121 (2000) ("Milo").

French law represents a variant of the Continental European model. It superimposes on the model a registered "enterprise charge" (*nantissement sur fonds de commerce* or *fonds artisanal*) that is a cross between the American floating lien and the English floating charge. In French law unregistered interests, such as the rights of a seller that has retained title, are enforced and have priority over the rights of a liquidator and other creditors in insolvency. Registration is required to create certain types of fixed charges, but not for what in the U.S. would be purchase money security interests to have priority in insolvency.

The English model. Third, there is a broad group of countries that follow the English system of secured transactions. The English system recognizes the "floating charge," a security device different in key respects from the American "floating lien" and one which does not neatly fit into the Article 9 framework. In the English system, a registered floating charge – which may be granted only by a company, not an individual – floats on the debtor's assets but does not attach to them until an event of "crystallization" such as default, insolvency, or levy of execution. Without registration the floating charge cannot come into existence. At the moment of crystallization, the floating charge becomes a fixed charge on whatever assets the debtor owns at that time. Prior to crystallization, however, the debtor is free to grant fixed charges such as chattel mortgages which upon being registered, take priority over the earlier-registered floating charge. In addition, prior to crystallization the debtor may sell property that is subject to the charge and a good faith purchaser will receive the property free of the charge. Finally, prior to crystallization statutory liens may be fixed in the assets of the debtor and they, too, will take priority over the floating charge.

In the English model, security interests may be given by individuals by way of a bill of sale pursuant to Bills of Sale Acts based on the English Bills of Sale Act. Bills of sale may be registered, but rarely are.

The Latin American model. A Model Inter-American Law on Secured Transactions drafted on behalf of the Organization of American States ("OAS") follows the general lines of Article 9, and may be enacted shortly by Guatemala. However, Latin American laws on secured transactions are based on the civil law system and unregistered title retention and fiduciary title devices are generally enforceable against the interest of a bankruptcy receiver or trustee. To the extent that registrable security devices exist, they are fragmented according to the business of the debtor and the type of lender. Agrarian pledges are governed by different laws than industrial pledges. Financial institutions are permitted to take certain security interests that other lenders cannot. Divergent registration systems with inconsistent rules govern different types of security devices.

Moreover, many registration systems in Latin America are poorly organized and unreliable, and in some cases, not open for public inspection, casting doubt on whether they pass the "generally available" test. Most of these registries were designed for annual or semi-annual updating of business association corporate or societal records. In the interim, a prospective lender

that wishes to find out whether the inventory or the accounts receivable or the sales proceeds of the borrower have been pledged and if so to whom and for approximately how much, the registry could not supply such information. High registration fees also encourage the use of title retention and fiduciary title devices rather than registered security devices.

Problems in Applying Rev. §9-307(c) to Foreign Filing, Recording and Registration Systems

No Clear Bright Line: "Generally Requires" and "Generally Available" Requirements

Rev. §9-307(c) requires a secured lender or seller to evaluate whether the personal property filing, recording or registration system of the debtor's country meets certain standards. If foreign law "generally requires" the filing of nonpossessory security interests in personal property to achieve priority over lien creditors, and if the filing system is "generally available" and hence gives adequate public notice of such security interests, then the secured party must perfect in accordance with foreign law. If foreign law does not pass this test, the secured party must perfect under D.C. law.

What the drafters contemplated may have been that a consensus would emerge about the adequacy of different countries' filing systems so that secured lenders and sellers could, in effect, color-code a map of those countries whose systems passed or did not pass the Rev. §9-307(c) equivalence test – e.g., England yes, Germany no. Reality is not so simple.

Filing System Limitations as to Types of Debtors or Secured Parties

For example, a large number of countries, including most Latin American countries, limit registration of nonpossessory security interests to certain types of debtors. A seller selling goods to an industrial or agricultural company located in a country that requires, and permits, registration only if the debtor is an industrial or agricultural company shouldn't have to worry about whether a purchase money security interest could be registered if the debtor were a services company or an individual. Yet Rev. §9-307(c) forces the lender or seller to worry about these irrelevancies.

Another problem concerns countries such as Taiwan that preclude the use of their registration systems by foreign lenders that are not authorized to make loans in that country, or preclude registration of documents if the loan is denominated in foreign currency. If a country's registration system satisfies the equivalence test but is effectively closed to foreign lenders, the effect under Rev. §9-307(c) is that it is impossible to perfect a nonpossessory security interest in the personal property of any debtor located in that country.

Uncovered Types of Collateral

The "color-coded map" idea of Rev. §9-307(c) creates another problem. Suppose a country's registration system for nonpossessory security interests in personal property passes the equivalence test; it "generally requires" filing to achieve priority over a lien creditor and the information in its registration system is "generally available". That alone would not ensure that a lender or seller could perfect by registering, because there might be particular categories of collateral that are not covered by the registration system. Since the country's registration system as a whole passes the §9-307(c) equivalence test, registration would be the only way to perfect a security interest. Yet if the proposed collateral is not covered by the country's registration system, there would be no way at all for the lender or seller to perfect its interest. Rev. §9-307(c) would make a filing in D.C. meaningless if the foreign country's registration system passes the equivalence test. The country is colored "yes" on the map, yet the answer for the lender or seller that wants to extend credit on collateral not covered by the country's registration system is "no way." A lender extending credit on the security of a type of collateral that is covered by the registration system – say, equipment - shouldn't have to be concerned with whether registration would be required of security interests in other types of collateral, e.g., accounts or general intangibles.

No Deference To Conditional Sales, Fiduciary Title And Constructive Redelivery

Another issue regarding Rev. §9-307(c) ultimately concerns how much deference to give to foreign laws. Many civil law countries, including Austria, Germany and the Netherlands among others, use conditional sales, title retention or transfer and constructive delivery rather than filing and registration systems to perfect what in the United States would be classified as nonpossessory security interests. A German debtor buying equipment under a conditional sale contract, for example, probably would have to permit the seller to label the equipment as property of the seller until the price has been fully paid, and the seller or a fiduciary titleholder would retain the unqualified right to possession of the equipment unless the parties have circumvented this problem by a device such as constructive redelivery to the seller or a lease-to-own arrangement. In contrast, Rev. §9-307(c) accords no deference to these unregistered security devices.

Practical Adequacy of Filing Systems

Yet another concern about Rev. §9-307(c) is that it does not take into account the adequacy of the actual functioning of foreign filing systems, only whether foreign law "generally requires" filing and whether the system is "generally available." Argentina, for example, has a registration system with broad application on paper, but its registries, though available to the public, are notoriously fragmented and outdated. Are its records "generally available" even

though they will often yield erroneous information? Furthermore, if an American lender were to determine that Argentina fails the equivalence test at present due to these practical inadequacies, and in reliance on that determination files only in Washington, D.C., would the lender's security interest cease to be perfected if a zealous registrar in Argentina a year later cleans up and updates the registries in his or her part of the country?

Public Access to Filing System

A number of civil law countries such as Hungary that require notarization of security agreements and related documents have established central notarial registers that may be accessible only to notaries, who in such countries are highly trained lawyers. Is the information in these registration systems "generally available" for purposes of Rev, §9-307(c), even though the public is not allowed to inspect them? If the lender or seller has to retain a notary anyway to create and perfect its security interest, it shouldn't matter whether non-notaries have access to the records.

A further problem is presented by countries such as China where local registries are controlled by functionaries who are given virtually unbridled discretion to determine who will have access to the information contained in the system. Such discretion invites abuse.

What's a "Lien Creditor"? What's a "Security Interest"?

There are numerous types of statutory liens, not only in the United States but in many foreign countries. Not all foreign countries treat all lien creditors the same way vis-à-vis registered security interests. If a foreign filing system puts the secured party with a registered interest above some lien creditors but beneath others in priority, does that country's filing system pass the equivalence test?

Moreover, while bankruptcy trustees generally have the status of a lien creditor under the "Strong-Arm Clause," 11 U.S.C. §544(a), other countries do not endow bankruptcy trustees with this status, or do not have bankruptcy trustees at all.

Lawyers from civil law countries often have difficulty understanding the concept of a security interest, because it violates the *numerus clausus* of Roman law on which the civil law of property is based. Switzerland has a registration system for fiduciary title and title retention arrangements; most other Continental European countries do not. Are fiduciary title and title retention "security interests" even though foreign laws do not recognize the concept?

The Effect of Foreign Choice of Law Rules

Two foreign filing regimes that almost certainly would be considered to satisfy the equivalence test of Rev. §9-307(c) are the Personal Property Security Acts

("PPSA's") adopted in Canada and New Zealand, which are based on pre-Revision Article 9. However, the PPSA's, like pre-Revision Article 9, require perfection in accordance with the law of the place where the collateral is located. A New York lender lending to an Ontario corporation on the security of collateral located in New York is directed by Rev. §9-307(c) to file in accordance with Ontario law, yet Ontario law says to file in accordance with New York law. Can the New York lender safely ignore the choice of law provision of the PPSA's and file only in Ontario – where the filing might be considered ineffective due to the absence of the collateral– and not in Washington, D.C.?

Would the UCC Fail the Rev. §9-307(c) Test?

It is ironic that the drafters thought they were drafting a statute that required lenders and sellers to compare foreign filing systems with the UCC filing system. Again taking Rev. §9-307(c) literally, the Article 9 filing system would not pass its own equivalence test but for the statement in Official Comment 3, second paragraph, that a "jurisdiction that has adopted this Article or an earlier version of this Article" would satisfy the test. Purchase money security interests in consumer goods doubtless represent the largest absolute number, though perhaps not the largest dollar volume, of security interests in the United States, yet the UCC does not require the filing of a financing statement to perfect them. Thus, the UCC cannot be said to "generally require" filing to perfect security interests, unless the universe of security interests is restricted to non-consumer transactions. Rev. §9-307(c), however, contains no such restriction.