Security Interests in Accounts Receivable and Inventory in Common Law and Civil Law Jurisdictions

Secured lenders, especially working capital lenders, are no doubt familiar with the framework of secured lending laws provided by Article 9 of the Uniform Commercial Code ("UCC"). The UCC, designed to facilitate commercial transactions, governs the creation, perfection and enforcement of security interests in personal property. The salient features of the UCC that permit this are (i) security interests in personal property not limited to specific existing assets, rather attaching to entire categories or types of assets, whether of a static nature such as fixtures on specific real property, or of a type constantly changing such as accounts receivable and inventory ("Liquid Collateral"), (ii) a uniform filing system for the perfection and public notification of the existence of liens to creditors, (iii) a prioritization of competing security interests or claims and (iv) a uniform set of rules for enforcement of security interests in personal property.

When dealing with security interests in assets in foreign countries a secured lender will find that many of these UCC principles are not found in local law. As foreign courts will rarely give any weight to US law security documents, secured lenders should be aware of the differing forms of legal systems and security interest rules they may face in cross border lending transactions. For ease of illustration we will examine how such legal systems treat the type of collateral that secured lenders are most familiar with, Liquid Collateral.

Differences Between Common and Civil Law Legal Systems

The UCC is an outgrowth of the common law legal system. This system originated in old English law and has a tradition of development based on court decisions and the legislative process. In this system the legislature adopts a law and the courts are left to interpret, clarifying the law’s meaning and in many instances expanding the law’s scope. Due to this duality of change mechanism, common law is thought to be more readily adaptable to changing circum-

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stances and has developed a more flexible approach to commercial transactions. In contrast, in the civil law system the legislature alone creates and changes laws - the court systems' only responsibility is to apply and enforce the law instead of interpreting it to fit varying situations and contexts. As a result, it is thought that the civil law system is much less adaptable to changing times and circumstances, as with the case of laws governing commercial transactions. Set forth below is a brief general description of the ways in which civil law systems vary from the UCC in their treatment of security interests in Liquid Collateral. In addition, we have included specific examples of the application of common law and civil law principles in dealing with the creation, perfection, ranking and enforcement of security interests in Liquid Collateral in three commercially important countries: the United Kingdom (which follows the common law system); and France and Germany (which follow the civil law system).

Specificity Requirement/Floating Liens

Under the UCC a security interest may be created in broadly described categories of assets, such as “accounts receivable” and “inventory”. There is no requirement that individual items of collateral be identified or that the borrower (“Borrower”) even have rights to collateral at the time it grants the security interest. These are the principles of the “Floating Lien”, or a lien that attaches to a type of collateral that by its nature is constantly changing, for instance through the turnover of inventory or the creation and collection of accounts receivable. In addition, this security interest applies to all such property in which the Borrower has rights whether these rights exist in the present or arise in the future (the “after acquired property” concept). The UCC specifically provides that the Borrower may create such a property interest in an account receivable even if the account debtor desires to restrict the right of the Borrower to do so.

In contrast, under the civil law system, the concept of a Floating Lien is either nonexistent or, due to the strict limitations put on this security device, is of little practical value to a secured lender. Civil law countries typically require that collateral be specifically described. For accounts receivable, this may mean a detailed description including date incurred, name of account debtor and amount. This requirement may work for a limited grouping of existing accounts, but would not be workable for a secured lender providing working capital financing against Liquid Collateral. As a corollary, this specificity would not permit a security interest in an account receivable not yet created. For inventory this requirement would entail a description of location, quantity and type. Again, this requirement is not conducive to a business where inventory is constantly turning over and may pass through several locations that the Borrower uses to manufacture, distribute and sell inventory.

Lien Registration/Perfection of Lien

Under the UCC, a secured lender receives a grant of a security interest for Liquid Collateral pursuant to a security agreement and perfects that security interest by making a single filing in the Borrower’s jurisdiction of organization with the secretary of state’s office. This filing also serves the purpose of giving national notice to all claimants of the existence of a security interest in the Borrower’s Liquid Collateral.

In contrast, most civil law jurisdictions lack a central filing system for perfection or notice of liens. Instead, heavy reliance on actual notice of the lien to third parties, such as a requirement to directly notify an account debtor of the existence of a lien on accounts receivable, is required. In the case of inventory, although some jurisdictions may have a rudimentary filing system, the preferred method (and sometimes the only practical method) of establishing the lien and its perfection against third parties is for the secured lender to take physical control of the inventory. In short, these limitations on perfection and notice to claimants coupled with the lack of a viable Floating Lien concept make secured lending against Liquid Collateral very unattractive in civil law jurisdictions.

Priority of Perfected Secured Interests

The UCC provides a uniform set of rules for determining the priority of liens of competing claimants. In contrast, under the civil law system, due to the lack of a centralized filing and notification system, a secured lender may have to rely solely upon the good faith representation of the Borrower as to the existence and/or priority of competing claims. This last point is illustrated by the civil law’s recognition of a supplier’s right of retention of title. Under the UCC, in order to retain title to inventory transferred to a Borrower, a supplier must file a financing
statement to perfect and publicly disclose its security interest. In many European countries, the supplier continues to own the goods after they are received by the Borrower and the supplier’s rights continue until the supplier is paid for the goods sold. Furthermore, a supplier’s right of retention of title has priority over the inventory security interests of the secured lender on the theory that the Borrower cannot assign to the secured lender collateral which it does not yet own.

Enforcement

Under the UCC, upon default a secured lender may (i) sell collateral and apply the proceeds to the satisfaction of the secured debt or (ii) if the Borrower does not object, retain the collateral in satisfaction of the secured debt. In addition, the UCC permits a secured lender to collect payments directly from account debtors. In contrast civil law jurisdictions generally require the use of a court appointed receiver to foreclose on collateral that is not in the secured lender’s possession. As this receiver typically answers to the court, a secured creditor may have no control over disposition of its collateral, and may also suffer significant delays in receiving proceeds of collateral.

In conclusion, obtaining and perfecting security interests in Liquid Collateral is generally practicable in common law tradition countries and impracticable in civil law tradition countries. For those transactions involving a Borrower with substantial foreign operations carried on through foreign subsidiaries, a pledge of the foreign subsidiaries’ stock may be the only viable method of obtaining some credit support from such subsidiaries’ assets.

Select Jurisdictions’ Treatment of Security Interests

COMMON LAW SYSTEM

UNITED KINGDOM

As the United Kingdom is the cradle of the common law system, it is not surprising that many of the same concepts underlying UCC provisions for security interests in Liquid Collateral also apply in the UK. As such, UK law recognizes the concept of a Floating Lien and provides for a national registry of certain security interests. However, it is from this point that UK law and the UCC diverge.

To create a security interest in Liquid Collateral under UK law, one must first choose between a “fixed charge” and a “floating charge”. Although each type of charge will attach to the same collateral (although it is not totally settled that a fixed charge may be applied to Liquid Collateral) they result in a differing (i) amount of required control by the secured lender of the collateral and (ii) priority against third party creditors.

A fixed charge is a security interest that gives a secured lender the greatest priority against competing claimants. However, to enjoy the benefits of this device, a secured lender is required to have a high degree of control over the collateral. This would include the requirement that the secured lender consent to any disposition of the collateral, even for dispositions of inventory and other collateral in the ordinary course of the Borrower’s business. In addition, the secured lender must receive and have control of the proceeds. As a result, it would be cumbersome for a Borrower to carry on its ordinary course of business if its assets were subjected to such a charge. If this degree of control is not present then, regardless of how the charge is styled, it would be treated as a “floating charge”.

A floating charge is a security interest applied to constantly changing assets of the Borrower. The Borrower is allowed to use, collect or dispose of the covered assets in the ordinary course of business and the floating charge automatically attaches to any new items of similar nature. Floating charges remain over the property they are intended to affect, leaving the Borrower free to sell, buy and vary the assets subject to the charge until the Borrower defaults at which time the floating charge fixes on a then existing specific asset or assets. This process of fixing on an asset or group of assets is called “crystallization” of the charge. When a floating charge crystallizes (i.e., converts into a fixed charge), the secured lender can deal with any of the assets then existing.

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Floating charges over accounts receivable are further broken down into “equitable” and “legal” charges. The primary difference is that a “legal charge” gives a better priority to the secured lender, but requires that (i) the account debtors be notified of the charge as a prerequisite to perfection of the security interest and (ii) payment of the account receivable be made to the secured lender. As this is an event a Borrower would be reluctant to permit, the equitable charge, which does not require such notice, is much more common.

UK law provides for a central registration of equitable charges with the “Registrar of Companies” at the “Company House”. This registration is effective with respect to accounts receivable against persons, such as other financial institutions, likely to search for such liens at the Companies House. As against this class of creditors, the registered equitable charge will have priority. However, disputes could arise as to whether competing claimants were in the category of “likely to search”. The only solution to this quandary would be to convert the equitable charge to a legal charge by notifying the account debtors.

Another important distinction between a fixed charge and a floating charge relates not only to their relative ranking against each other but also against the “preferential creditors” of the Borrower. In every case a fixed charge will rank ahead of a floating charge even if the fixed charge is created after the granting of a floating charge on the same collateral. Further, preferential creditors holding “preferential debts” would, in an insolvency or bankruptcy of a Borrower, rank below fixed charges, but ahead of floating charges on the same collateral. Examples of preferential debts include payroll taxes, value-added tax, employee salaries and social security contributions. In practice, because a floating charge is required to perfect a charge over inventory or accounts receivable, a secured lender’s charge on these assets will be junior to the claims of the preferential creditors. Therefore, it is common practice in the UK for the secured lender to require reporting by the Borrower as to the amount of preferential creditor claims, monitor their status and establish reserves against the borrowing base for such collateral.

UK law gives the holder of a lien over all or substantially all of a Borrower’s assets a powerful tool for enforcement of this lien. Such a holder can reserve for itself the right to appoint an “administrative receiver”, a position created under Section 29 of the Insolvency Act of 1986. This power has three primary advantages (i) an administrative receiver answers to and is directed by the secured lender, (ii) the appointment of such an administrative receiver prevents the appointment of an ordinary “administrator” which would answer to the court and not the secured lender and (iii) the administrative receiver, may, upon court approval, cause the sale of an asset even if it is encumbered by a prior lien if the administrator can show a superior recovery may result. The right to appoint an administrative receiver must be exercised diligently since the prior appointment of an ordinary “receiver” would block the subsequent appointment of the administrative receiver. If the secured lender delays and an ordinary receiver is appointed, the secured lender could lose control of the foreclosure process and may suffer considerable delay in recovering on its claim.

**CIVIL LAW SYSTEM**

**GERMANY**

German law recognizes the Floating Lien concept, but it is subject to severe limitations. Security interests are created and perfected by the parties entering into security documentation called “security assignments”. Collateral in a security assignment must be described with sufficient specificity so as to be readily identifiable. General collateral descriptions creating a Floating Lien under the UCC would not be recognized in Germany.

In the case of inventory collateral, to meet the definiteness standard required under German law, such collateral will necessarily be limited to described inventory at a specific location. If the Borrower moves the inventory to another location the secured lender must prove that the inventory collateral was originally at the location identified in the security assignment. Similarly, as applied to accounts receivable, the specificity requirement requires identification of the Borrower’s accounts receivable by customer, address, amount, invoice number, etc. The practical consequence here is that the secured lender will need a list and description of the receivables subject to the security assignment.

German law does not provide for a central registry for security interests. Because security assignments are private agreements between the secured lender and the Borrower, a secured lender must rely upon the Borrower’s representations as to the absence of or relative priority of competing liens.
A secured lender may not act independently to foreclose on Liquid Collateral not in its possession. As to accounts receivable, a security assignment is considered part of the insolvency estate preventing the secured lender from collecting the accounts receivable directly.

Under German law, a court appointed insolvency administrator (not subject to the direction of the secured lender) must foreclose on Liquid Collateral not in the secured lender’s possession. The receiver’s fees and charges are paid from the proceeds of any collateral before the secured lender is entitled to any proceeds from the sale or other disposition of the collateral. These fees and charges can be a significant percentage of any recovery. In addition, the secured lender may suffer substantial delays in obtaining any recovery. Secured lenders may protect themselves against this by taking an appropriate reserve against the Borrower’s borrowing base.

FRANCE

In keeping with the civil law tradition, France does not recognize the Floating Lien concept with respect to Liquid Collateral. With respect to inventory, unlike German law, France does not have an alternative device to obtain a perfected security interest in inventory. With respect to accounts receivable, a secured lender, may only take a security interest in an account receivable that exists. Under traditional French law, to obtain the security interest the secured lender must receive an assignment of the account receivable. Furthermore, to be effective against other creditors or in bankruptcy, the account debtor must be notified of the assignment - either a “huissier” (bailiff) must announce the assignment to the account debtor or the account debtor must accept the assignment under a prescribed formal proceeding.

The French legal system has adopted an alternative method known as the Dailly Act (Law no. 81.1 of 2 January 1981) for obtaining an assignment of accounts receivable. This act provides two methods for the collateral assignment of a group of accounts receivable, the “acte de nantissment” and the “acte de cession”. Both methods require the delivery of a detailed listing of the receivables (a Dailly Slip). Since this method does not provide for future accounts, it is necessary for the periodic delivery of Dailly Slips listing the receivables to the secured lender. This method does not require notification of account debtors for perfection of the security interest or to establish priority of the security interest in the listed accounts receivable. Title to the accounts receivable is transferred to the assignee (secured lender) by way of security. The assignee may notify the third party account debtor that it must no longer pay its creditor (the assignor) and will only be released from its debts to the creditor if it pays the amount due to the assignee. It is important to note that notification of or acceptance by the third party debtor is not necessary to perfect a valid security assignment of such accounts receivable. Such formalities are only meant to provide the assignee with additional protection.

One major drawback to the Dailly Act is that there is considerable uncertainty as to whether this device is available to secured lenders which are not either a French licensed banking institution or a European banking institution authorized to conduct a banking business in France. A secured lender should always consult local counsel with respect to whether they would qualify for the use of this security device. Accounts receivable secured under the Dailly Act methods are thought to be outside of bankruptcy proceedings and therefore subject to collection by the secured lender.

There is no national system of lien registration in France. Consequently the secured lender may receive comfort as to the absence of other liens only through representations of the Borrower.

A traditional assignment of accounts receivable coupled with the proper notification gives the secured lender a right to direct payment from the account debtor. Generally, assignments properly accompanied by notice are not difficult to enforce. If the Borrower fails to make timely payment, the secured lender may seek a “saisie-conservatoire” (order of attachment) against the Borrower’s assets or an “injonction de payer” (order directing payment).

In French bankruptcy proceedings, accounts receivable collateral not subject to a Dailly Slip arrangement is subject to privileged creditors’ prior claims. Such privileged claims include post-bankruptcy administration expenses, such as obligations to trade suppliers and other creditors arising after the beginning of the proceedings and, with judicial approval, the administrator can obtain new loans which have priority over the existing liens of all other secured creditors.
Other Jurisdictions of Note

CANADA

- The Personal Property Security Act (“PPSA”), is closely modeled after the UCC, and applies in all jurisdictions other than Quebec, Newfoundland and the Northwest territories.
- Security interests are perfected by registering a financing statement with a Provincial registration office. In some provinces, financing statements may be registered electronically, through on-line connections with the registration office.

MEXICO

- Unlike the US, Mexico does not have a single body of law governing secured transactions. Despite several legislative attempts to create schemes for liens on Liquid Collateral, Mexico does not have a workable system for secured lending against such collateral.