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Perfection of Nonpossessory Security Interests Under Revised Article 9: Consequences of the Practical and Conceptual Incompatibility of US and English Secured Transactions Law

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Article 9 of the Uniform Commercial Code ("UCC"), governing secured transactions, was recently revised, changing the way in which nonpossessory security interests are perfected.[1] All fifty states have approved the revision, which became effective in most states as of July 1, 2001. The changes affect foreign debtors differently depending upon whether their laws are compatible with revised Article 9. Given the sizeable amount of money that US banks loan to UK banks and corporations, English secured transactions law is particularly significant. This paper focuses on the incompatibility of English law with revised Article 9. The paper first examines the basics of where to file financing statements in order to perfect nonpossessory security interests under revised Article 9, contrasting the simplicity of determining the location of US debtors with the complexity of determining the location of foreign debtors. The paper then examines English law for compatibility with Article 9, because compatibility affects the method of determining the location of English debtors. Both practical incompatibility under current English law and possible conceptual incompatibility under future English law are considered. Finally, the paper highlights why filing must take place in the District of Columbia, notwithstanding the potential risks if a duplicate filing is not made in England.

I. DETERMINING DEBTOR LOCATION FOR PURPOSES OF FILING A FINANCING STATEMENT UNDER REVISED ARTICLE 9

An overview of the perfection of nonpossessory security interests under revised Article 9 is necessary in order to understand the added complications with foreign debtors. Most nonpossessory security interests are perfected by filing a financing

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1. A security interest is perfected when it becomes enforceable vis-à-vis third party creditors. The date of perfection generally governs the priority of secured creditors when the debtor is bankrupt or insolvent.

statement in the location of the debtor.[2] Registered US organizations are located in their state of registration. Foreign-registered organizations do not generally qualify for location based on state of registration because revised Article 9 requires that the state of registration be part of the United States.[3] The foreign-registered debtor may possibly be located at its "chief executive office," but neither the original nor revised Article 9 defines this term.[4] The case law pertaining to the original Article 9, which varies by jurisdiction, still applies in determining the location of the chief executive office of a foreign corporation.[5] There are generally only one or two possibilities for the location of the chief executive office, even under the varying case law standards.

If the foreign debtor's chief executive office always determined its location for filing purposes, the inquiry under the current case law would be relatively straightforward. The problem is that the foreign debtor is located in the place of its chief executive office only if the secured transactions laws of the foreign jurisdiction are equivalent to the Article 9 notice filing system.[6] If the foreign law proves unsatisfactory, the financing statement must be filed in the District of Columbia for the security interest to be perfected under revised Article 9.[7] This necessitates an analysis of the secured transactions law of the foreign jurisdiction to determine if filing in the District of Columbia is required.

II. PRACTICAL INCOMPATIBILITY OF ENGLISH LAW WITH REVISED ARTICLE 9

English law is incompatible with revised Article 9 because English law does not require notice filing of security interests. Article 9 generally requires the filing of financing statements to give notice of the creditor's specific nonpossessory security interests in the debtor's property. England does have a corporate secured transactions registration system, but the English system varies significantly from revised Article 9. The English corporate registration system is based on the registration of transactions

2. See UCC § 9-301(1) and cmt 4 (ALI 1999). But see UCC § 9-301 cmt 5 (listing some exceptions to the general rule).

3. UCC § 9-307(e), § 9-102(70), and § 9-102(76).

4. See UCC § 9-307(c) and cmt 2.

5. Hans Kuhn, *Multi-State and International Secured Transactions Under Revised Article 9 of the Uniform Commercial Code*, 40 Va J Intl L 1009, 1044–45 (2000) (setting forth the different tests in *Tatelbaum v Commerce Investment Co*, 262 A2d 494 (Md 1970); *Aoki v Shepherd Machinery Co* (*In re J.A. Thompson & Son, Inc*), 665 F2d 941 (9th Cir 1982); *Jarboe v United Bank of Denver* (*In re Golf Course Builders Leasing, Inc*), 768 F2d 1167, 1170–71 (10th Cir 1985); *Chase Manhattan Bank v Nemko* (*In re Nemko*), 209 Bankr 590, 601–12 (Bankr EDNY 1997)).

6. See UCC § 9-307(c).

7. Id.

rather than the filing of financing statements.[8] Registration of transactions after the fact creates a risk that a subsequent creditor will not have adequate notice.[9] More significantly, English law does not generally require notice filing, except in relation to corporations and certain special types of security interests.[10] Nor does English law generally condition perfection on notice filing, as required for compatibility with revised Article 9. Therefore, filing in the District of Columbia is required.

III. CONCEPTUAL INCOMPATIBILITY OF ENGLISH LAW WITH REVISED ARTICLE 9

It is possible that English law will eventually adopt a more universal notice filing system. However, English law contains one major element that makes conceptual compatibility with Article 9 unlikely: the floating charge. The floating charge enables a debtor to handle assets that are subject to a security interest without interference from the creditor, until such time as the debtor's management powers come to an end, either as a result of financial difficulties or the occurrence of an event under the provisions of the charge instrument.[11] Although Article 9 does not permit the equivalent of the English floating charge, it does permit a "floating lien."[12] The floating lien is similar to the floating charge in that it gives the debtor the ability to freely dispose of collateral without interference from the secured party. A floating lien under revised Article 9 can lose priority to competing interests notwithstanding notice filing, operating in the same way as the English floating charge. But loss of priority under Article 9 occurs only in very limited circumstances: for example, when a third-party buyer purchases inventory in the ordinary course of business.[13] A floating lien is limited to categories of property that are capable of being subject to nonpossessory security interests under revised Article 9, which excludes such things as money, deposit accounts, and letter-of-credit rights.[14] The floating charge is much broader,

8. See Philip R. Wood, *World-Wide Security—Classification of Legal Jurisdictions*, in Joseph J. Norton and Mads Andenas, eds, *Emerging Financial Markets and Secured Transactions* 43 (Kluwer 1998). See also A.L. Diamond, *A Review of Security Interests in Property* §§ 11.2.1–11.2.2 at 55 (HMSO 1989).

9. See UK ST 1989 ch 40 pt IV § 95 (requiring registration within twenty-one days of the charge's creation or date of acquisition).

10. See Diamond, *A Review of Security Interests in Property* § 10.6 at 51 (cited in note 8); Iwan Davies, *Floating Charges and Reform of Personal Property Legislation*, 9 Comp Law 47 (1988).

11. See R.M. Goode, *Legal Problems of Credit and Security* 48–51, 59 (Sweet & Maxwell 2d ed 1988).

12. UCC § 9-205 cmt 2.

13. See Douglas G. Baird, Thomas H. Jackson, and Randal C. Picker, *Security Interests in Personal Property* 156 (unpublished draft 2001) (describing the effects of UCC § 9-320(a)).

14. See UCC § 9-205 cmt 3 and § 9-312(b)(1–3).

potentially covering "all the property of the debtor, in all countries of the world."[15] The breadth of the floating charge makes it incompatible with revised Article 9.

Another similarity is that the English floating charge, like the floating lien under UCC § 9-205, must be registered in order to be perfected.[16] The requirements for initial registration of English floating charges are in some ways more detailed than the revised Article 9 registration requirements.[17] There are, however, some major conceptual differences that make registration of the floating charge fundamentally different from registration of the floating lien. Under Article 9, a floating lien must have already attached in order to be perfected. Attachment generally occurs when the creditor and debtor execute a security agreement. Once the combination of notice filing and attachment perfects the floating lien, priority is generally determined by the date of the notice filing. In contrast, a floating charge "is not a real right unless and until it 'crystallises'."[18] This creates an "intermediate state of perfected but non-specific or floating" prior to crystallization of the floating charge, which is not accommodated within the Article 9 notice filing system.[19]

Crystallization occurs when the debtor company goes into liquidation or receivership, or when its powers under the charge instrument come to an end.[20] Crystallization may be automatic upon occurrence of one of these events and does not require registration beyond the initial registration of the floating charge.[21] The secured creditor with a crystallized floating charge is protected from "an execution creditor who fails to complete his execution before crystallisation of the floating charge . . . even if he proceeds to complete the execution without notice of the fact that

15. George L. Gretton, *Mixed Systems: Scotland*, in Norton and Andenas, eds, *Emerging Financial Markets and Secured Transactions* at 289 (cited in note 8) (describing the English floating charge, which has been incorporated into Scottish law).

16. UK ST 1989 ch 40 pt IV § 93. See also Goode, *Legal Problems of Credit and Security* at 22–23 (cited in note 11); Philip R. Wood, *Comparative Law of Security and Guarantees* 117 (Sweet & Maxwell 1995).

17. See Wood, *Comparative Law of Security and Guarantees* at 114 (cited in note 16) ("In the US UCC states and in the English-based systems, only particulars of the security appear on the file, although in English-based systems the charge itself must be submitted for checking and return."). See also Diamond, *A Review of Security Interests in Property* § 11.2.4 at 55 (cited in note 8):

> The registration of transactions [in England] gives more information than notice filing [under the UCC], and in particular tells a searcher that a security agreement has in fact been entered into. . . . But it does not reveal whether any of the debt has been repaid, and unless it is compulsory to register the satisfaction of debts the charge shown may have ceased to exist. In most cases, therefore, detailed enquiry is necessary.

18. Gretton, *Mixed Systems: Scotland* at 286 (cited in note 15). See also Davies, 9 Comp Law at 50 (cited in note 10) quoting *Evans v Rival Granite Quarries Ltd*, 2 KB 979, 999 (1910) ("A floating security is not a specific mortgage of the assets, plus a licence to the mortgagor to dispose of them in the course of his business, but is a floating mortgage affecting any item until some event occurs or some act on the part of the mortgages is done which causes it to crystallise into a fixed security.").

19. Davies, 9 Comp Law at 48 (cited in note 10).

20. See Goode, *Legal Problems of Credit and Security* at 50–51, 59 (cited in note 11).

21. See id at 69.

there is a charge which has crystallised."[22] Automatic crystallization does not provide adequate notice of post-perfection attachment to other creditors, which creates incompatibility with revised Article 9 notice requirements. However, Article 9 does not necessarily disqualify a foreign secured transactions system that permits automatic perfection in limited circumstances.[23] It is not clear whether similar leeway exists for automatic attachment. Regardless, the prevalence of the floating charge in the English system makes it far from a limited exception. Attachment based on the time of crystallization leads to unpredictability and conceptual incompatibility with the notice regime of Article 9.

The floating charge not only prejudices other creditors, but often fails to protect its own holder from loss of rights in the collateral. Prior to crystallization, the floating charge is often unenforceable notwithstanding the notice provided by registration.[24] Priority may be lost vis-à-vis a "lien creditor" or "claims given a statutory preference in liquidation."[25] The floating charge thus runs counter to one of the major objectives of the Article 9 drafters, which is "to create a security interest that survives attack by the bankruptcy trustee."[26] The fact that a floating charge enables the creation of subsequent superior interests in the collateral threatens the "conceptual unity of the first-to-file scheme as a method of resolving priority disputes."[27] The prevalence of the floating charge in the English legal system probably prevents it from being compatible with revised Article 9.

IV. CONCLUSION

Given the differences between the English system of secured transactions and revised Article 9, registration in the District of Columbia is required to perfect a security interest in the United States. However, it is not clear that revised Article 9 takes the best approach to perfecting security interests over foreign debtors. The English system does not require registration in all circumstances, but nonetheless offers equivalent protection in many instances if that protection is desired by a US

22. Id at 90.

23. UCC § 9-307 cmt 3.

24. See UK ST 1986 ch 45 pt VI § 245. See also Goode, *Legal Problems of Credit and Security* at 40 (cited in note 11) ("[R]egistration does not guarantee priority against subsequent interests. This is so even where registration constitutes notice of the charge, for notice is not in all cases a determinant of priority.").

25. Baird, Jackson, and Picker, *Security Interests in Personal Property* at 157 (cited in note 13). See also Goode, *Legal Problems of Credit and Security* at 40 (cited in note 11) ("Priority of competing charges is governed by common-law rules . . . , not by the order of registration.").

26. Peter Winship, *Selected Security Interests in the United States*, in Norton and Andenas, eds, *Emerging Financial Markets and Secured Transactions* at 268 (cited in note 8).

27. Davies, 9 Comp Law at 50 (cited in note 10).

creditor who wishes to register in England.[28] The English system does not offer protection as complete as that of the UCC notice filing system, but it is perhaps unwise to invalidate filing in England on the basis of its failure to precisely match US legal standards. In some instances, registration in England will eventually be required if the category of property covered by the security agreement is either moved to England or acquired by an English debtor in the UK.[29] The registration requirement may even be retrospective to the date the security interest was created, invalidating the security interest due to the missed twenty-one day registration deadline under English law.[30] The advantages to registration in all permissible circumstances in the country where the debtor actually has its chief executive office outweigh the disadvantages of not having a precisely UCC-style registration system. It seems sensible to allow an equivalent type of registration in a foreign country, whether or not that registration would be required under local laws, in recognition of the fact that such registration offers greater protection to US creditors abroad. Nevertheless, under the revised Article 9, filing in the District of Columbia is required for all nonpossessory security interests of US creditors over English debtors. This will continue to be the case unless Article 9 is further revised to accommodate a broader range of foreign filing regimes.

28. See Goode, *Legal Problems of Credit and Security* at 80 (cited in note 11) ("[T]he registrability of most categories of security interest in one register or another makes it difficult for a subsequent legal purchaser to claim that he took without notice.").

29. See id at 39 (citing the holding of Lloyd in *NV Slavenburg's Bank v Intercontinental Natural Resources Ltd*, 1 All ER 955 (1980)).

30. Id. See also UK ST 1989 ch 40 pt IV § 95 (requiring registration within twenty-one days of the charge's creation or date of acquisition).