United States

Lawrence Safran, Joshua Stein and Mark Broude, Latham & Watkins LLP

www.practicallaw.com/5-384-6876

REAL ESTATE

1. Please briefly state what is considered real estate in your jurisdiction. What are the most common forms of security granted over it? How are they created and perfected (that is, made valid and enforceable)?

Real estate consists primarily of land ("from the centre of the earth to the sky"), buildings, and interests in land and buildings. These interests can consist of leaseholds, easements (the right to enter or use someone else's land or buildings), or other rights. Real property often also includes personal property (movables) that have been permanently attached to land or buildings, that is, "fixtures". Each state establishes its own law of real property. Although some general themes run through every state's real property law, each state has its own nuances and requirements, particularly on creation and enforcement of security. The discussion of real estate in this chapter reflects general US real property law, with some emphasis on New York law.

Forms of security in real property

Real property security instruments vary by state and consist primarily of:

- **Mortgages.** The most common real property security instrument is a mortgage, which can encumber any interest in real property that can legally be transferred (including, for example, absolute ownership, a tenant's interest under a lease, or the interest that a beneficiary of an easement holds). If the mortgagor (that is, the borrower, the party that granted the mortgage) fails to pay or perform an obligation, then the mortgagee (the holder of the mortgage, that is, the lender) can initiate an auction sale of the property, with the proceeds applied first toward the secured obligation.
- **Deeds of trust.** The borrower under a deed of trust conveys title to any real property to a third party trustee, who can either reconvey it when the loan has been paid or hold a trustee's sale if the loan is not paid. This puts the lender in the same position as if it held a mortgage.
- **Assignments of leases and rents.** Because a mortgage does not give the lender ownership of the collateral until a foreclosure sale or trustee's sale, the lender cannot collect rental income from the property until the sale has occurred. In response, lenders typically require borrowers to separately assign the rental income to the lender, from the moment of closing, so the lender can potentially collect the rents on any default, without waiting for a foreclosure or similar sale. Lenders usually do this in a separate document, outside the mortgage or deed of trust.

Creation and perfection of security interests in real property

Creation. All states first require that the borrower owns whatever real property they are mortgaging to the lender. (If the borrower holds a lease of real property, they own a leasehold interest, which they can mortgage, subject to the terms of their lease, but they cannot mortgage the landlord's interest.) The borrower must grant any mortgage or other security instrument by signing and acknowledging a written document. Each state also has its own technical requirements, such as how the real property must be described; technicalities for signatures and the language that must appear in the security instrument.

Perfection. To perfect any lien encumbering real property, the lender must record its security instrument in the official land records that cover the location of the real property, typically the county hall of records. Recordation often requires compliance with a number of technical requirements, payment of taxes and fees, and delivery of supplemental documents. It is not necessarily automatic or simple. It typically leads to issuance of a policy of title insurance, where a title insurance company assures the lender that it holds a valid lien encumbering the real property described in the policy. Such coverage typically costs up to about 0.2% of the amount of the insured lien.

TANGIBLE MOVABLE PROPERTY

2. Please briefly state what is considered tangible movable property in your jurisdiction, for example, machinery, trading stock (inventory), aircraft and ships? What are the most common forms of security granted over it? How are they created and perfected?

In the US, a security interest in most personal property, including most tangible movable property, is governed by the Uniform Commercial Code (UCC), a model law enacted in each US state and the District of Columbia. Article 9 of the UCC governs security interests in personal property. Although largely uniform from state to state, each state's version of the UCC varies in some ways from the model text. The discussion in this chapter reflects the "model" text of the UCC, unless otherwise stated. US federal law and international treaties that bind the US can sometimes pre-empt the UCC. Article 9 of the UCC excludes certain types of property and certain transactions from its scope, such as, in

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most states, most insurance policies, interests in real property, and a sale of accounts, chattel paper, payment intangibles, or promissory notes, as part of a sale of the business out of which they arose. For such property and transactions, other non-uniform state law applies.

Under the UCC, the term "goods" includes everything that is movable when a security interest attaches. The term therefore includes:

- Inventory (generally goods held for sale or lease or raw materials used or consumed in a business).
- Equipment (such as machinery).
- Fixtures (goods that have become so related to particular real property that an interest in them arises under real property law).
- Standing timber to be cut.
- Unborn young of animals.
- Crops grown or growing.
- Manufactured homes.

Scope of the term security interest and scope of the UCC

Under the UCC, the term security interest is very broad. It starts with an interest in personal property or fixtures that secures payment or performance of an obligation. It includes retention of title by a seller of goods, as well as many consignments of goods. The UCC treats the interest of a buyer of accounts, chattel paper, payment intangibles, or promissory notes as a security interest. Article 9 of the UCC applies to any "transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." Therefore, the UCC treats as the creation of a security interest, many transactions that on the face of it appear like something else. The UCC's special requirements for consumer transactions are not covered in this chapter.

Creation of security interests generally

Under the UCC, to be valid and enforceable against the borrower or other grantor of a security interest (debtor), a security interest in personal property and fixtures must first attach. For this to happen, value must be given, and the debtor must:

- Have (or have the power to transfer) rights in the collateral.
- Enter into an adequate security agreement, sufficiently describing the collateral.

The UCC does not require that the debtor receives value reasonably equivalent to the value of the collateral. If it is not, however, and the debtor becomes insolvent, then a bankruptcy court might set aside the security interest as a "fraudulent transfer" (*see Question 18*).

A party granting a security interest can usually only create a security interest in whatever rights it has in the collateral, whether such rights consist of absolute ownership or lesser rights such as a leasehold interest.

Usually, the UCC requires a written or electronic security agreement, that describes the collateral and is signed or otherwise authenticated by the electronic equivalent of a signature. The UCC also defines how the security agreement must describe the collateral. A description such as "all assets" or "all personal property" would not suffice in a security agreement. Instead, the UCC establishes a set of rules for how collateral must be described. Although rarely used in commercial transactions, in some cases, an oral security agreement may suffice.

Once a security interest has attached, it is valid between the borrower and the secured party, entitling the secured party to exercise remedies if unpaid. However the secured party must also "perfect" the security interest, making it effective against future third parties, particularly future creditors of the same borrower and, most importantly, any bankruptcy trustee if the borrower were to file bankruptcy.

Main ways to perfect security interests in goods

The UCC establishes two main ways to perfect a security interest in goods:

- Filing an appropriate UCC financing statement (this is the typical way).
- Possession of the goods by the secured party (generally uncommon).

A UCC financing statement is a filing designed to put other creditors on notice of the secured party's security interest in the collateral identified by the financing statement. The financing statement must include information about the grantor and the secured party (such as name and address) and a description of the collateral. The most critical item is the name of the grantor. It should match exactly the grantor's legal name. If the security agreement allows it, a financing statement can validly describe the collateral as "all assets". This is not sufficient in a security agreement.

For most collateral, including most goods, a single financing statement in the debtor's "location" will suffice. Determination of the debtor's location varies depending on the type of debtor. If the debtor is a domestic corporation, limited liability company, or limited partnership, their location is usually the state under whose law they were organised (often Delaware). A general partnership is usually located at its chief executive office. A natural person will be located at his principal residence. Special rules govern foreign chartered entities, entities organised under US federal law, trusts, and some other entities. For collateral closely associated with real property (such as fixtures, timber and minerals and gas before extraction), the UCC requires special filings in the official land records for most debtors.

Financing statements generally lapse five years after filing unless a continuation statement is filed in the six months before the lapse date. Changes in the name, location or organisational structure of the grantor may require a new financing statement or an amendment of a previous one before it would otherwise lapse.

If a secured party perfects its security interest by possession, the secured party can have a third party possess the collateral on the secured party's behalf. That third party cannot, however, be the debtor.

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If the collateral consists of goods evidenced by a bill of lading, a warehouse receipt, or a similar document, then instead of filing a UCC financing statement, a secured party can perfect its security interest by taking certain actions regarding that document. If the document is negotiable, the secured party can perfect by taking possession of it. Otherwise, the secured party can perfect by either notifying the document issuer of the secured party's security interest or having the document issued in the secured party's name.

Security interest in proceeds generally

If a secured party holds a perfected security interest in collateral (original collateral) and the collateral produces proceeds (that is, a revenue stream, insurance payment, or some other form of property derived from the original collateral), the secured party will automatically have a perfected security in those proceeds for 20 days after the borrower receives them. A security interest in identifiable cash proceeds remains perfected after that 20-day period. Other rules govern other types of proceeds.

Special rules for certain types of goods

Certain types of goods are subject to special laws outside the UCC. The most common examples that arise in commercial lending are:

- **Aircraft and certain aircraft-related assets.** The US has ratified the Cape Town Convention on International Interests in Mobile Equipment and the related Aircraft Protocol. Perfection of a security interest in these assets requires registration at the international registry in Dublin, Ireland, and the US portal in Oklahoma City, Oklahoma.
- **Ships.** Under the Ship Mortgage Act, filing a ship mortgage with the Secretary of Transportation is required for certain ships and other vessels.
- **Railroad rolling stock.** Security interests in railroad cars, locomotives and other rolling stock now require recordation with the US Surface Transportation Board.
- **Motor vehicles.** The UCC governs creation (attachment) of security interests in motor vehicles. When motor vehicles constitute inventory held for sale or lease by a person in the business of selling motor vehicles, such as for a car dealer, the UCC governs perfection of any such security interests. Otherwise, state "certificate of title" laws apply, usually requiring notation of the security interest on the certificate of title.

SHARES AND FINANCIAL INSTRUMENTS

3. What are the most common forms of security granted over financial instruments, such as shares and other securities (both in certificated and dematerialised form)? How are they created and perfected?

The UCC's rules vary depending on the financial instrument, for which there are four main classifications:

Investment property

This includes:

- Securities.
- Security accounts.
- Commodities contracts.
- Commodities accounts.

Securities include both debt and equity securities, either certificated or uncertificated. If securities or certain other financial assets are credited to a securities account, this produces a form of investment property called a security entitlement. Commodity contracts include:

- A commodity futures contract.
- An option on a commodity futures contract.
- A commodity option.

Deposit accounts

These include:

- Demand accounts.
- Time accounts.
- Savings accounts.
- Passbook accounts.
- Similar accounts maintained with banks, but not evidenced by an instrument.

An account to which securities are or may be credited is a securities account, not a deposit account.

Instruments

These are written evidence of a right to payment, but that are:

- Not a security agreement or lease;
- Transferred by delivery with endorsement; and
- Not a certificated security.

A promissory note is the type of instrument most often seen.

Chattel paper

This evidences a monetary obligation and a security interest in, or lease of, specific goods. The most common form arises from the sale or lease of a specific motor vehicle. Chattel paper can be either written (tangible chattel paper) or electronic (electronic chattel paper).

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Creation of security interests in financial instruments

For creation of a security interest in any financial instrument, the same principles apply as for security interests in goods (*see Question 2*).

Perfection of security interests in financial instruments

A secured party can perfect a security interest in investment property, instruments, or chattel paper by filing a UCC financing statement (*see Question 2*). Filing will not, however, perfect a security interest in a deposit account as original collateral (in contrast to a deposit account that constitutes proceeds). A secured party with possession or control of investment property, an instrument or chattel paper, will have priority over another secured party that perfected its interest solely by filing, regardless of when the financing statement was filed. Therefore, if a transaction involves a material amount of this type of collateral, a secured party will often require possession or control.

A security interest in instruments, tangible chattel paper, or certificated securities can be perfected by possession. Perfection does not require endorsement, but it can produce some benefits. Therefore, an endorsement in blank is common for both instruments and certificated securities.

A security interest in uncertificated securities, electronic chattel paper, securities accounts, deposit accounts, commodity contracts, or commodity accounts cannot be perfected by possession but rather by "control". For deposit accounts, securities accounts and uncertificated securities, probably the most common method of achieving control is by a "control agreement" between the debtor, the secured party, and the bank or securities intermediary that maintains the account (or the issuer of the uncertificated security). In a control agreement, the bank or securities intermediary (or securities issuer) agrees to comply with the secured party's instructions or orders (for example, directions to release the collateral to the secured party) without the debtor's further consent. An analogous concept applies to commodity contracts.

The UCC offers some other methods to achieve control. For example, the secured party can become the registered owner of an uncertificated security, or the customer or entitlement holder (essentially, the account holder) of a deposit account or securities account. In some cases, the secured party can be entitled to automatic control (for example, if the secured party is the bank that maintains a deposit account). Each method of control has its pitfalls, however, so counsel should be consulted. The rules governing control of electronic chattel paper are extremely complex and counsel should be consulted before implementing this method of perfection.

The UCC also governs sales of chattel paper and promissory notes. The UCC treats a buyer's interest in these assets as a security interest. A buyer of chattel paper must perfect its security interest, but a buyer of promissory notes will be automatically perfected.

CLAIMS AND RECEIVABLES

4. What are the most common forms of security granted over claims and receivables (such as debts or rights under contracts)? How are they created and how are they perfected?

Assets in this general category fall within the following classifications under the UCC:

- **Accounts.** These principally include the right to payment of a monetary obligation for property sold or otherwise disposed of or for services rendered, but also including certain other property.
- **General intangibles.** This consists of any personal property except those specifically listed in Article 9 of the UCC (generally software, intellectual property, and rights under a contract not in any other UCC category). If the counterparty's primary obligation under a general intangible is monetary, then it falls under the "payment intangibles" subcategory.
- **Commercial tort claims.** This includes claims for damage to a business, as opposed to under a contract or agreement, except a claim for personal injury or death.
- **Letter of credit rights.** This is a right to payment or performance under a letter of credit.

Instruments and chattel paper might also be viewed as falling within this general category (*see Question 3*).

Creation of security interests in claims and receivables

The rules for creation of a valid security interest in accounts, general intangibles, letter-of-credit rights and commercial tort claims generally mirror those for goods (*see Question 2*). For commercial tort claims, however, the security agreement must also specifically identify the claims subject to the security interest.

Any security interest in claims and receivables also often raises issues about whether the debtor can even assign its interest to the secured party. The UCC will override certain restrictions on assignment either in whole or in part. It will not, however, override all restrictions. In addition, if the obligor on the receivable or other claim is a governmental entity, compliance with special statutory requirements may be necessary.

Perfection of security interests in claims and receivables

Perfection of a security interest in accounts, general intangibles, and commercial tort claims as original collateral requires a UCC financing statement (*see Question 2*). To the extent the collateral consists of commercial tort claims, the UCC requires some additional details in describing it.

A UCC financing statement cannot perfect a security interest in a letter of credit right as original collateral. That would require the issuer or nominated person to consent to an assignment of the proceeds of the letter of credit to the secured party. If, however, a letter of credit supports payment or performance of any account, chattel paper, document, general intangible, instrument,

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or investment property (an underlying obligation), then the UCC calls the letter of credit a "supporting obligation." In that case, if the secured party perfects its interest in the underlying obligation, the secured party will automatically hold a perfected security interest in the letter of credit as a supporting obligation. The secured party cannot, however, draw on the letter of credit unless the debtor has actually transferred the letter of credit to the secured party.

Similarly, attachment and perfection of a security interest in any right to payment under the UCC that is itself secured by a security interest or other lien on personal or real property also constitutes automatic attachment and perfection of a security interest in the underlying security interest, mortgage, or other lien. However, in the case of notes secured by mortgages, a secured party often records an appropriate notice in the land records.

The UCC also applies to sales of accounts and payment intangibles, treating the buyer's interest as a security interest. A buyer of accounts must perfect its security interest, but a buyer of payment intangibles is automatically perfected.

INTELLECTUAL PROPERTY

5. What are the most common forms of security granted over registered and unregistered intellectual property (such as patents, trade marks, copyright and designs)? How are they created and perfected?

Creation of security interests in intellectual property

The rules to create a security interest in patents, trade marks and copyrights generally mirror those for goods (*see Question 2*). Federal trade mark law, however, generally invalidates any assignment of a trade mark without an assignment of the related goodwill. If the grantor does not own particular intellectual property but has only a licence to use it, the licence may prohibit or limit assignment. Federal trade mark law prohibits an absolute assignment of a trade mark application.

Perfection of security interests in intellectual property

The UCC and US federal law both govern security interests in patents, trade marks and copyrights. For a registered copyright, a filing with the US Copyright Office usually suffices. All other categories require at least a UCC financing statement. For a patent or trade mark, a federal filing can protect the secured party from certain additional third party claims. Given the uncertainty in this area, secured parties often file under both the UCC and, where available, US federal law.

PROBLEM ASSETS

6. Are there types of assets over which security cannot be granted or is difficult to grant? Consider the following and give brief details of any additional requirements:

- **Future assets.**
- **Fungible assets (a pool of assets indistinguishable from each other that may change over time).**
- **Other assets.**

Real property law theoretically allows a borrower to grant a mortgage lien encumbering all real property it later acquires in the same county where the mortgage document was recorded. Although such a lien may attach as between the borrower and the mortgage lender, third parties (most importantly the borrower's trustee in bankruptcy) will typically not be bound by it, because the documentation does not adequately describe this additional mortgaged real property. Therefore real estate lenders do not rely on clauses of this type.

In contrast, the UCC allows a debtor to create a security interest in future assets (including rights in an asset that do not rise to full ownership). Though common, such security interests do not attach, until the borrower actually acquires its interest in the particular asset. Intellectual property, commercial tort claims, and some other categories of after-acquired property may require further filings or other actions. These security interests do not attach at all to assets that the borrower acquires after bankruptcy, unless they constitute proceeds of assets in which the secured party already had a perfected security interest.

COMMERCIAL SECURITY

7. What types of commercial or quasi-security (that is, legal structures used instead of taking security) are common in your jurisdiction? Is there a risk of such structures being re-characterised as a security interest? Consider the following and give brief details:

- **Sale and leaseback.**
- **Factoring.**
- **Hire purchase.**
- **Retention of title.**
- **Other structures.**

The following legal structures are used as alternatives to taking security:

Sale and leaseback

Here, a seller conveys property to the buyer, who simultaneously leases the property back to the seller, often with an option to repurchase. The "buyer" will often finance the transaction by placing its own mortgage or security interest on the property it acquired.

If such a transaction involves UCC property, the UCC may reclassify it as creation of a security interest. Whether such reclassification occurs depends on the facts of each case. A court will, however, reclassify it as the grant of a security interest, if the consideration that the lessee is to pay for the right to possession

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and use of the goods is an obligation for the term of the lease, not subject to termination by the lessee and any one of these four factors exists:

- The original lease term equals or exceeds the remaining economic life of the goods;
- The lessee must renew the lease for the remaining economic life of the goods or must become the owner of the goods;
- The lessee has an option to renew the lease for the remaining economic life of the goods for no (or nominal) additional consideration on compliance with the lease agreement; or
- The lessee has an option to become the owner of the goods for no (or nominal) additional consideration on compliance with the lease agreement.

When any material risk of reclassification exists, the buyer will typically take the steps necessary to perfect a security interest in the same property.

If a sale and leaseback transaction involves real property, the courts may reclassify it as a mortgage based on the above considerations, but it typically remains possible. If reclassification risk exists, the parties often record a "protective" mortgage, like perfecting a "protective" security interest in personal property.

Tax and accounting concerns often drive any sale and leaseback, forcing the parties to structure the business terms in a way that meets various tax and accounting tests.

Factoring

A factoring transaction involves the sale of accounts receivable at a discount, to compensate the factor for bearing the risks of delayed payment and non-payment. The UCC treats a factor as a secured party, and its interest as a security interest, which the factor must perfect (*see Questions 3 and 4*).

Hire purchase (known as closed-end leasing or lease purchase)

The automobile industry commonly uses closed-end leases (under that name, not hire purchase). This arrangement gives a lessee the use of property for a fixed term, and the right to buy it for an agreed residual value after the lease term.

Retention of title

A seller sells and ships goods but purports to retain title until paid. Though such arrangements are not uncommon in the US, the UCC treats them as outright sales with the buyer holding a security interest to secure payment. Therefore, the seller will not be deemed owner of the goods. It must perfect its security interest (*see Question 2*). Its security interest is just like any other security interest before, during, and after the buyer's insolvency or liquidation.

Instalment sale

Here the buyer takes delivery of goods and pays for them over time, with the seller purporting to retain title until paid. Assuming the seller delivers possession of the goods, this transaction is legally similar to retention of title.

RISK AREAS

8. Do company law rules affect taking security? In particular:

- **Financial assistance rules. For example, if a company grants security to secure debt used to purchase its own shares (or the shares of its holding company), does this breach such rules?**
- **Corporate benefit rules. For example, if a subsidiary grants security relating to a loan to its parent, does this breach such rules?**
- **Other rules?**

Unlawful financial assistance

A company's grant of security to secure debt to purchase its own shares (or the shares of its holding company) is not restricted by any specific financial assistance rules beyond any principles of corporate law that otherwise limit a company's ability to purchase its own shares.

Corporate benefit rules

Generally, under state law, if the directors of a subsidiary company decide to grant security for a loan made to its parent, and make this decision on an informed basis, in good faith, and with loyalty to the company, the courts traditionally defer to the directors' business judgment (*see also Question 18, Fraudulent conveyance*).

9. Can a lender holding or enforcing security over land be liable under environmental laws, even if it did not cause any pollution of the land?

Federal law (the Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA) imposes almost automatic environmental liability on owners and operators of facilities that cause contamination, subject to limited exemptions for mortgage lenders.

Before foreclosure, a mortgage lender may avoid liability by avoiding control of decision making about the collateral (a principle that gives lenders another good reason to avoid taking control of their collateral).

After foreclosure, exemption depends on what the lender does to dispose of the property, and how quickly. These are all factual determinations that may depend on discretionary determinations by judges and administrators. CERCLA does not exempt parties that purchase contaminated property from lenders. Therefore, any selling price for contaminated collateral post foreclosure will reflect the contamination. State environmental laws do not necessarily offer exemptions for mortgage lenders.

Lenders generally mitigate environmental risk through due diligence and, sometimes, environmental insurance.

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THE COMMERCIAL DEBT MARKET

10. Is contractual subordination of debt possible and common? If so, how can it be achieved, for example by an inter-creditor agreement between senior, mezzanine and junior creditors? Is structural subordination possible?

Creditors can agree to subordinate the right to payment of the claims they hold against the debtor, the security for those claims, or both. In the case of payment subordination, the debt instrument identifies the obligation as "senior debt" or "subordinated debt" within the company's capital structure, and describe the subordination. The various creditors also often enter into inter-creditor agreements, particularly if the subordination involves security interests or liens. These agreements will further define the subordination, and often limit or condition the exercise of remedies by the junior creditor, and sometimes the senior creditor.

Layers of debt can also be structurally subordinated to one another. For example, an operating subsidiary can incur one layer of debt, while its parent, the holding company, incurs a second layer. The holding company will pay its debt only from net profits of the operating subsidiary, that is, only after the operating subsidiary has paid its layer of debt. Therefore the holding company's debt becomes structurally subordinate to the operating subsidiary's debt.

11. Is secured debt traded in your jurisdiction? If so, what transfer mechanisms are used? How do buyers ensure that they obtain the benefit of the security associated with the transferred debt?

Lenders regularly trade interests in secured debt. Most substantial commercial loan documents assume that such trading will occur. In addition to direct assignments of interests in loans, indirect interests called participations also sometimes occur. Typically, syndicated loan documents appoint an agent to hold all security for the lender group.

An assignee of an interest in the loan will need to comply with the credit agreement assignment requirements in order to become an assignee of any interest in the loan. The assignee will not, however, need to do anything more to obtain the benefit of the security interest the agent holds.

In the less common case where no agent exists and all lenders hold direct security, legal issues will arise over who can enforce the security and how a lender transfers its interest in the loan.

12. Is the trust concept recognised in your jurisdiction? If not:

- **Is a trust created under the law of another country recognised in your jurisdiction?**
- **Can a security trustee enforce its rights in the courts in your jurisdiction?**

US law recognises both common-law and statutory trusts. If the real purpose of a trust is to secure payment or performance, however, the UCC will treat the arrangement as the grant of a security interest, subject to the same requirements for attachment and perfection (*see Question 2*).

A security trustee can enforce its rights in the courts. It may, however, need to qualify to do business in the particular jurisdiction to use the courts of that jurisdiction. The qualification process varies from state to state, but is typically not burdensome and counsel can readily achieve it.

13. Do the different types of security in your jurisdiction need to be documented separately or does your jurisdiction allow a single security document?

Lenders usually obtain mortgages or other real property security instruments for real property (plus a separate assignment of rents if the property produces rental income), and security agreements or pledge agreements for personal property. Although mortgages and deeds of trust usually also create security interests in personal property closely associated with the real property (for example, building materials, cleaning equipment, and tools), if the debtor is not primarily in the real estate business the secured party will usually require a separate security agreement to create a security interest in a range of personal property subject to the UCC.

If the collateral includes a material amount of intellectual property, the borrower will typically sign short form security agreements for filing (*see Question 5*). If the secured party perfects its security interest by obtaining "control" (*see Question 3*), this will often require separate third-party agreements.

ENFORCEMENT AND INSOLVENCY

14. Please briefly state the circumstances in which a secured creditor can enforce its security, for example, when an event of default occurs? What requirements must the creditor comply with?

If a borrower fails to pay or perform a secured obligation, the loan documents generally call this an event of default and allow the secured party to foreclose and exercise other rights and remedies, arising under the documents or general law. Loan documents often require the secured party to give the borrower notice of default and a certain time to cure the default before the secured party can foreclose. (However, the borrower does not often have this protection for defaults in paying principal or interest.) In addition to non-payment, loan documents may define events of default to include the following, often again subject to notice and opportunity to cure:

- Material inaccuracy in a representation or warranty.
- Failure to perform certain covenants.
- A default or acceleration of other debt of the same borrower or a guarantor of the loan.

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- Insolvency or certain bankruptcy proceedings (although bankruptcy law limits the enforceability of any such event of default).
- Prohibited transfers of collateral or of ownership interests in the borrower.
- Problems with the lender's security.

An event of default typically allows the lender(s) to block future advances, accelerate unpaid principal, assess default interest, foreclose, and exercise other rights and remedies (*see Question 15*).

15. How are the main types of security interest usually enforced? What requirements must a creditor comply with (for example, a mandatory public sale of the secured asset through the courts)?

Personal property and fixtures

If an event of default occurs, the secured party must first decide whether to seek a judicial foreclosure of the collateral (that is, go to court) or exercise its "self-help" remedies under the UCC. Judicial foreclosure protects the secured party from the risk that a court will later decide that the secured party's self-help violated applicable law. Judicial foreclosure can be slow and costly, though, so it will rarely be a secured party's first choice.

A secured party's principal self-help remedies consist of:

- Selling the collateral at a public or private sale.
- Proposing to keep the collateral in full or partial satisfaction of the debt.

A secured party cannot purchase collateral at a private sale unless the collateral is of a kind customarily sold on a recognised market, or is the subject of widely distributed standard price quotations. Therefore, if the secured party wants to acquire the collateral, this usually requires a public sale, not a private one. Whether a sale of the collateral is public or private, every aspect of the process (including method, manner, time, place, and notice) must be commercially reasonable. If it is not, the lender may find itself liable to the borrower and third parties, and could also lose its "deficiency" claim against the debtor if the sale does not produce enough proceeds to pay the debt. Any sale will also require various notices to the debtor and other creditors.

If the secured party proposes to retain collateral in full or partial satisfaction of the debt, the debtor can accept or reject the proposal after default. Any pre-default agreement of this type is unenforceable. Acceptance also requires concurrence (or at least failure to timely object) by others holding subordinate interests in the collateral.

If the collateral includes a right to receive money from a third party, the secured party may be able to collect that payment directly from the third party.

The "automatic stay" provisions under the Bankruptcy Code (*see Question 17*) and state law further limit a secured party's exercise of remedies against any collateral.

Real property

Although a foreclosure sale or trustee's sale usually constitutes the primary remedy for any real estate loan in default, lenders often have other rights and remedies, which may resolve the loan without the need for a sale. Those might include:

- **Action to pay debt.** On an event of default, the lender typically has the right to require immediate payment of the entire loan. The lender can then sue the borrower to collect, unless the loan is "non-recourse" or state law procedures require the lender to foreclose first.
- **Power of sale.** Most states allow the lender to hold a non-judicial sale of the collateral. By complying with specified procedures, the lender can have the property auctioned off without involving a judge. The proceeds of the sale go first to repay the secured debt. Any balance goes to the borrower or holders of junior liens.
- **Possession.** Most commercial mortgages allow the lender to take possession of the collateral after an event of default. The lender can collect revenue, pay expenses, and apply remaining funds toward the debt. Some state laws limit or discourage lenders from taking possession. More generally, lenders hesitate to take possession for fear of liability and claims, particularly under environmental law.
- **Receivership.** After an event of default, the lender can generally have a court appoint a third party to take control of the collateral, collect the rents, and hold any net income pending resolution of the foreclosure action. In some states (for example, New York) appointment of a receiver is almost automatic. Other states make it quite difficult.
- **Bankruptcy.** Once a lender starts to exercise the above rights and remedies, the borrower will often file for bankruptcy to attempt to obtain more time to keep the collateral. Bankruptcy gives a lender certain rights and protections that it would not have had outside bankruptcy, and may ultimately facilitate a quicker and cleaner resolution of the loan, although this will depend very much on circumstances (*see Question 17*).

When any lender exercises remedies, issues may arise about amounts that the lender owes to the borrower, such as bank deposits of the borrower held with the lender, or conceivably other obligations running from the lender to the borrower. US law allows these obligations to be credited against one another (set-off) only in certain circumstances. The requirements and procedures vary from state to state but generally require the following:

- Mutuality (that is, the same parties in the same capacities, though not necessarily in the same transaction).
- Any amount to be claimed as a set-off can be quantified and is not subject to future contingencies.
- Payment is presently due.

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Before a lender exercises any set-off rights, however, it must first confirm with counsel that doing so complies with any notice requirements and will not impair other rights and remedies.

16. Are company rescue or reorganisation procedures (outside of insolvency proceedings) available in your jurisdiction? If yes, please give brief details, including voting requirements to approve such procedures. How do they affect a secured creditor's rights to enforce its security?

Except through private consensual restructurings of debt (for which the voting requirements appear in the loan documents), no company rescue or reorganisation procedures exist under US law, outside insolvency proceedings under bankruptcy law. State debtor-creditor law often provides for orderly liquidation proceedings, but these proceedings cannot reorganise a company without the concurrence of everyone involved. In contrast, bankruptcy reorganisation can.

17. How does the start of insolvency procedures affect a secured creditor's rights to enforce its security?

If a creditor has not properly perfected its security interest or other lien, then a court can set it aside. Even a properly perfected security interest can face avoidance in bankruptcy (*see Question 18*).

If a security interest is properly perfected and is not so avoided, the secured party is entitled to receive the value of its interest in the collateral up to the amount of the secured obligations. The value of a secured party's interest in its collateral generally means the value of the collateral minus any obligations secured by a more senior security interest. If the value of the creditor's interest in the collateral exceeds the secured obligations, the secured party may be entitled to continue to accrue interest after the date the debtor filed its bankruptcy petition.

Starting on that date, however, federal law imposes an automatic stay that prevents the secured party from doing anything to enforce its collateral during the bankruptcy proceeding. Subject to a few limitations, the automatic stay suspends all litigation, collection, foreclosures, and repossessions of property, to give the debtor some breathing room.

A secured lender can sometimes obtain relief from the automatic stay. For example, under a Chapter 11 bankruptcy (reorganisation), if the borrower lacks equity in certain property not necessary to an effective reorganisation, the court might, on the secured lender's application, modify or terminate the automatic stay.

Any bankruptcy court has broad powers to restructure a secured obligation if:

- The secured creditor retains its lien on its collateral.
- The restructured obligations give the secured creditor payments that have a present value, as of the effective date of the reorganisation plan, at least equal to the value of the creditor's interest in its collateral.

State law imposes other limitations on a secured lender's exercise of remedies in relation to its security.

18. What transactions granting security can be made void if the entity that granted the security becomes insolvent? Please briefly state the time limits that apply and the conditions that must be met for the security to be made void.

Fraudulent conveyance

The US Bankruptcy Code and similar state fraudulent conveyance laws allow a court to set aside (as a fraudulent transfer) a borrower's secured obligation, or an affiliate's guarantee or grant of security for a borrower's obligation, under certain circumstances. Actual fraudulent intent (that is, an intention to defraud, delay, or hinder creditors) is not necessary, but if it exists it will often suffice. Without such intent, a court looks at the financial characteristics of the transaction.

The court first asks whether the party granting security or a guaranty received "reasonably equivalent value" in exchange. If they did, then the transaction should not be set aside.

If the guarantor or grantor did not, then a court may set aside the transaction if the guarantor or grantor:

- Was insolvent after the transaction (including any subsequent extensions of credit);
- Was engaged in a business for which it had unreasonably small capital; or
- Intended to (or believed it would) incur debts beyond its ability to repay.

Creditors seeking to set aside a transaction have two years to act under US bankruptcy law, or up to six years under state law. Each period is measured backwards from the date of a bankruptcy filing.

Preferences

Even if a secured party properly perfects its security interest, the borrower's bankruptcy trustee may still be able to invalidate it if the borrower:

- Granted the security interest to secure pre-existing indebtedness;
- Was insolvent at the time; and
- Files bankruptcy within 90 days after granting the security interest. This 90-day "preference period" becomes a year if the secured party is an "insider" of the borrower (for example, a director, officer, or controlling shareholder).

Ordinary secured creditors can run into preference problems in any number of ways, for example:

- **Delayed perfection of initial security interests.** If a secured party obtains a security interest and then takes more than 30 days to perfect it, the act of perfection can be a transfer

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on account of pre-existing indebtedness. After perfection, if the borrower files for bankruptcy protection within the preference period, the lender may face a preference attack on its security interest.

- **After-acquired property.** A security agreement might give a secured party a security interest in property the borrower acquires in the future. In this case, the security interest cannot arise until the borrower acquires rights in that particular after-acquired property. Therefore, even if a lender perfected its security interest years before the borrower's bankruptcy filing, to the extent that the borrower acquired new assets in the preference period before the filing, the security interest may face preference attack. This problem will not usually arise, though, if the new collateral consists of inventory, accounts receivable, and proceeds of existing collateral.
- **Future grants of security interests.** To the extent that a borrower further secures existing debt by granting a security interest over assets that were not subject to the initial security interest, a new preference period begins.

19. Please list the order in which creditors are paid on the borrower's insolvency, assuming the security interests have been validly perfected. Consider:

- **The secured creditors considered in *Questions 1 to 5* (please set out any order of priority applying between the security interests).**
- **Statutory claims (such as tax or other government claims, expenses of the insolvency proceedings and employee claims).**
- **Unsecured creditors.**
- **Subordinated creditors.**

A secured lender's claims generally have priority over unsecured claims of other creditors (including trade creditors, employees, landlords, and senior unsecured noteholders), to the extent that the collateral has realisable value.

Although a lender must perfect its security interest to obtain priority, this does not always ensure priority over every possible third party. Certain third parties can still have priority under state and federal law, under some complex rules beyond the scope of this chapter.

In a corporate insolvency, the debtor's property will usually be distributed in this order:

- Secured creditors (for priorities among secured creditors, *see Question 20*).
- Expenses of insolvency proceedings.
- Certain employee claims, tax claims and government claims.
- Unsecured creditors.
- Subordinated creditors.
- Shareholders.

A bankruptcy court can, however, sometimes alter these priorities. For example, a court can:

- Subordinate one claim to another claim.
- Re-characterise certain debt as equity.
- Confirm a reorganisation plan that varies from the usual distribution rules.

20. If more than one creditor holds the same security interest over the same asset, how is priority between them determined? Please briefly set out any specific ranking rules that apply.

When two creditors hold perfected security interests in the same personal property, priority will usually go to the creditor that either perfects its security interest first or files its financing statement first. Secured parties that perfect by obtaining possession or control of collateral often prevail over a secured party that perfects only by filing a financing statement, regardless of when they filed. Some lenders, such as one who provides funds for a borrower to purchase a particular asset, may have special priority, if they meet certain technical requirements under the UCC. Any secured party can voluntarily agree to subordinate.

When two creditors hold mortgages encumbering the same real property, state law will determine the relative priority of their claims. In general, whichever creditor validly records its mortgage first will obtain priority. Many states also impose an additional requirement: the lender that recorded first must have made its loan without knowing about the other lender's mortgage.

21. If a security interest has not been validly perfected, where does the security holder rank on the borrower's insolvency?

A lender that fails to perfect its security interest before bankruptcy will usually become unsecured. Outside bankruptcy, that lender may still sometimes be able to enforce its security interest, but an unperfected security interest usually provides very little value.

CROSS-BORDER ISSUES

22. Are there restrictions on granting security (over all forms of property) to foreign lenders? If yes, please give brief details, for example registration requirements.

Foreign lenders can generally take security in the same manner that US-based lenders can. Foreign lenders may, however, need

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to make state filings (for example, qualify to do business) before they can exercise rights and remedies or own and operate collateral. These requirements vary from state to state.

23. Are there exchange controls that restrict payments to a foreign lender under a security document or loan agreement?

No general exchange controls prevent a foreign lender from repatriating proceeds realised in the US by enforcing security or collecting a loan. Anti-terrorism and similar legislation can prevent payments to lenders in certain countries deemed to support terrorism or otherwise considered hostile to the US.

24. Is a foreign choice of law clause in a security document recognised and applied by the courts in your jurisdiction? Does local law always apply in certain circumstances?

State law governs recognition of choice of law clauses. For personal property security documents, the UCC provides that when a transaction bears a reasonable relation to this state and also to another state or nation, the parties may agree that the law of either this state or of such other state or nation will govern their rights and duties. This freedom does not extend to choosing the law that governs the perfection, effect of perfection or non-perfection and priority of a security interest, because these issues implicate the rights of third parties. However, the contracting parties can usually choose which state's law will govern the validity of the security interest and the contractual enforceability of the security agreement. Even though the UCC is generally uniform, choice of law sometimes makes a huge difference, when it implicates either the contract law of a particular state or non-uniform provisions of the UCC.

Under real property law, the parties can choose which state's law will govern their contractual relationship, that is, the relationship they would have if no security existed. For substantial or multi-state transactions, the parties often choose New York law for this role. To the extent that a secured mortgage loan raises issues about the transfer of interests in real property, enforcement of a mortgage or other security instrument, control of rental income, and similar real property issues, the law of the state where the property is located applies and the courts of that state have exclusive jurisdiction and authority to act.

TAX AND FEES

25. Are taxes or fees paid on the granting and enforcement of security? Consider the following and state the tax rates and fee amounts, if they are more than a nominal amount:

- **Documentary taxes (for example, stamp duty).**
- **Registration fees.**
- **Notaries' fees.**

State and local (but not federal) taxing authorities impose fees of these types, which vary from state to state. For any real property collateral, these fees are generally nominal, with two major exceptions:

- About a quarter of the states impose a mortgage recording tax or documentary stamp tax on mortgages. In New York, for example, that tax can run as high as 2.8% of the loan amount.
- If a secured lender forecloses, some states tax the resulting transfer as if it were a voluntary sale. In New York, for example, that tax can reach as high as 3.025% of the loan amount. A carefully structured bankruptcy filing and plan of reorganisation has traditionally been the preferred technique to eliminate this tax, while mitigating mortgage recording tax on the next refinancing.

For UCC financing statements, most jurisdictions impose nominal filing fees. As a notable exception, Tennessee calculates the fee as a percentage of the secured obligation, and it can therefore become substantial. Florida imposes a documentary stamp tax on UCC filings, which can usually be avoided by signing documents outside Florida. The US Patent and Trademark office and the US Copyright Office impose nominal fees to file security interests. Notation of a lien on a motor vehicle certificate of title also involves a filing fee. Although the fee per vehicle is modest, the costs add up if the secured party wants to appear on certificates of title for a large pool of vehicles.

In contrast to many European jurisdictions, notary fees in the US are generally nominal. The notary public's role is limited to confirming signatures. Almost anyone can qualify to become a notary.

26. If such taxes and fees make granting security too expensive, are there strategies to minimise costs?

Generally, taxes and fees for the granting or taking of security are not high enough to require such strategies. A few states, however, do impose high taxes on creating and enforcing security interests, particularly in real property. Although New York offers the most extreme example, similar problems arise in Florida, Maryland, and a few other states. Local counsel can typically advise on tax mitigation strategies, usually on a case-by-case basis. These strategies, often counter-intuitive and difficult, can drive the entire security documentation structure, so must be considered early in the life of a transaction or resolution of a defaulted loan.

REFORM

27. Please summarise any proposals for reform and state whether they are likely to come into force and, if so, when.

The following summarises a few pending proposals for revisions in the law. It remains to be seen whether any such revisions would constitute reform or merely change.

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Article 9 of the UCC, which governs security interests, was effectively re-written in 2001. Since then, a few issues have arisen. A committee is considering whether those issues justify any changes to the statutory text or official commentary. One of the largest issues relates to the definition of the correct legal name of an individual person who is a debtor. This issue is crucial to the effectiveness of financing statements under those circumstances, so a uniform solution has been sought and seems probable. Wholesale revision of Article 9 appears unlikely.

Article 1 of the UCC contains definitions and rules that apply throughout the UCC. An entirely revised version of Article 1 has been promulgated. About two thirds of the states have enacted it, at least in part. No state has adopted (or seems likely to adopt) revisions to Article 1 that would give the parties even more freedom of contract than they already have in choosing which state's law will govern their transaction. 11 states have expanded the old definition of good faith ("honesty in fact in the conduct or transaction concerned") to include "the observance of reasonable commercial standards of fair dealing." Further adoption of that change seems likely.

The credit crisis has led US courts to try to save homes by imposing on mortgage lenders extensive requirements for documentation, particularly proof of record ownership of the note and mortgage being foreclosed. Given the recent widespread loan trading and securitisation, these requirements have become quite burdensome, causing substantial delays and defences in residential foreclosures. It remains to be seen whether courts will take a similar approach in commercial foreclosures, even without concern about saving homes.

The bankruptcy courts have been tightening up on borrowers' use of federal bankruptcy plans of reorganisation as a device to mitigate transfer taxes on transfer of collateral to the lender. This trend will probably continue.

Standardised legislation has been proposed (but not widely adopted) to eliminate the need for separate assignment of rents documentation, replacing it with certain automatic rights for mortgage lenders to obtain access to property rental income. This would simplify some ancillary documents and perhaps eliminate some issues in contested foreclosures.

If the US were to join the 2007 Rail Protocol to the Cape Town Convention on Mobile Equipment, filing at the international registry in Luxembourg would be required for railway rolling stock subject to this Rail Protocol. This filing could either replace or supplement the filing now required with the US Surface Transportation Board.

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CONTRIBUTOR DETAILS

Lawrence Safran, Joshua Stein and Mark Broude
Latham & Watkins LLP

T +1 212 906 1711
+1 212 906 1342
+1 212 906 1384
F +1 212 751 4864
E *Larry.Safran@lw.com*
Joshua.Stein@lw.com
Mark.Broude@lw.com
W *www.lw.com*

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