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# Retention of Title Disputes: Don’t Take the Uniform Commercial Code for Granted

This article reminds us of the conflict-of-laws analysis at the heart of such retention of title disputes, and then discuss the multi-step UCC analysis that is also required.

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Secured lenders to U.S. companies should generally expect to defeat competing retention of title claims asserted by foreign vendors, but this should not be taken for granted. The supporting legal framework is open to judicial interpretation and requires a disciplined application of numerous Uniform Commercial Code (UCC) terms. For an outcome that many secured lenders assume without much hesitation, applicable law does little to justify easy confidence.

This article reminds us of the conflict-of-laws analysis at the heart of such retention of title disputes, and then discuss the multi-step UCC analysis that is also required.

The following is a useful retention-of-title hypothetical. A lender enters into a credit agreement with a U.S. company, and the lender is granted and perfects in a first-priority security interest in the company's domestic accounts receivable and inventory. The company regularly purchases inventory from an overseas vendor pursuant to a distribution agreement that states title to the product does not pass until the company pays all amounts due to the vendor. The governing law under this contract is a foreign law (such as in the United Kingdom) that enforces retained title provisions. The foreign vendor does not file a UCC financing statement in the U.S. The company eventually defaults on its loans from the secured lender, and the company cannot fully pay both the vendor and its lender. Can the secured lender foreclose on the company's inventory located in the U.S.? Can the company sell such inventory and pay the proceeds to the secured lender?

The UCC suggests an answer, but it also begs other questions. Pursuant to UCC Section 2-401(1), "[a]ny retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest." U.C.C. §2-401(1). Thus, the UCC would limit the effect of a retention-of-title provision to only reserving a security interest in the product, leaving UCC priority provisions to operate normally after that. But, how do we know the UCC applies to the cross-border transaction? Why doesn't the UCC respect the ability of parties to select other law to govern? Those threshold questions require several steps to address.

This first step involves a conflict-of-laws analysis, which normally occurs in federal court because the dispute involves foreign companies or bankruptcies. Accordingly, the Restatement (Second) of Conflicts of Laws (the Restatement) is front and center. *See, Huynh v. Chase Manhattan Bank*, 465 F.3d 992, 997 (9th Cir. 2006) ("[f]ederal common law follows the approach outlined in the

Restatement (Second) of Conflict of Laws"). Two main provisions of the Restatement are at the core of this analysis, Section 187 and Section 6.

Section 187 of the Restatement provides, in relevant part:

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

Restatement (Second) of Conflicts of Law §187(1)-(2) (1971).

The express selection of foreign law by the company and the vendor will be valid under Section 187(1) of the Restatement as well as under Section 187(2) of the Restatement so long as such foreign law has a substantial relationship to the vendor agreement. Thus, to the extent that an international commercial contract contains a choice-of-law provision favoring a foreign law relevant to the transaction or parties, such foreign law should govern the

choice-of-law analysis. This is not a good start for our hypothetical secured lender.

However, Section 187 of the Restatement has been generally interpreted to be enforceable only against contracting parties and not against a third-party that is a "stranger" to the contract — *i.e.*, "[t]he law of the state *chosen by the parties* to govern *their contractual rights and duties* will be applied." Restatement (Second) of Conflicts of Law §187(1) (emphasis added). In our hypothetical, the secured lender is not a party to the supply arrangement and has no contractual rights or duties in that regard. Accordingly, Section 187 of the Restatement should not be applicable.

Section 6 of the Restatement offers a different approach to fill the gap. Section 6(1) of the Restatement provides that "[a] court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law." *Id.* at §6. And, the comment to Section 6(1) even refers to the UCC as the type of local law that should apply when Section 6 is implicated:

The court must apply a local statutory provision directed to choice of law provided that it would be constitutional to do so. *An example of a statute directed to choice of law is the Uniform Commercial Code* which provides in certain instances for the application of the law chosen by the parties and in other instances for the application of the law of a particular state. … Statutes that are expressly directed to choice of law, that is to say, statutes which provide for the application of the local law of one state, rather than the local law of another state, are comparatively few in number.

*Id.* at cmt. a (internal citations to 1971 version of the UCC omitted) (emphasis added).

When Section 6 of the Restatement directs parties to the UCC's choice-of-law provisions, the obvious next step is to apply them. But, beware: the UCC's conflict-of-laws provisions may refer the parties back to the foreign law. UCC Section 1-301 begins by providing that parties may select the law that will govern their transaction, so long as the transaction bears a reasonable relation to the state or foreign nation selected. This is strike two for our hypothetical secured lender.

If we keep reading, subsection (c) of UCC Section 1-301 carves out certain "sacred" UCC provisions that may not be varied by an agreement of the parties:

1. Section 2-402;
2. Sections 2A-105 and 2A-106;
3. Section 4-102;
4. Section 4A-507;
5. Section 5-116;
6. Section 6-103;
7. Section 8-110;
8. Sections 9-301 through 9-307.

Notably, Section 2-401 (*i.e.*, the retention-of-title UCC provision from the beginning of this article) is excluded from the list. And, that would be strike three for the secured lender if the byzantine analysis ended there.

UCC Section 1-301(c)(8) prevents parties from contracting away matters governed by UCC Sections 9-301 through 9-307. UCC Sections 9-301

through 9-307 contain the pertinent conflict-of-laws rules. UCC Section 9-301 provides:

(1) Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or non-perfection, and the priority of a *security interest* in collateral. … (3) Except as otherwise provided in paragraph (4), while negotiable tangible documents, *goods*, instruments, money, or tangible chattel paper is located in a jurisdiction, the local law of that jurisdiction governs: …

(C) the effect of perfection or nonperfection and the priority of a nonpossessory security interest in the collateral.

U.C.C. §9-301 (emphasis added).

The term "security interest" is, in turn, defined in UCC Section 1-201(35) which says: "[t]he retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer under Section 2-401 is limited in effect to a reservation of a 'security interest.'" U.C.C. §1-201(35). Thereby, a retention-of-title claim ***is*** a security interest for UCC purposes and covered by UCC Section 9-301, which may not be varied by contract pursuant to UCC Section 1-301(c)'s list of mandatory provisions. In this twice-removed way, UCC Section 2-401 becomes the operative law for determining the contest between our US secured lender and foreign vendor.

This eventual outcome makes sense. Secured lenders in the U.S. should be able to rely generally on pre-closing lien searches and their own perfection steps to assure their rights and priority in collateral located in the U.S. As Official Comment 4 to UCC Section 1-301 emphasizes, "Article 9 parties

taking a security interest or asked to extend credit which may be subject to a security interest must have sure ways to find out whether and where to file and where to look for possible existing filings." U.C.C. §1-301, cmt. 4. To the extent that this issue has been litigated, courts generally follow the foregoing analysis and have come to the same conclusion on the retention-of-title conflict. *See*, *Usinor Industeel v. Leeco Steel Products, Inc.*, 209 F. Supp. 2d 880, 882 (N.D. Ill. 2002). *Hong Kong and Shanghai Banking Corp., Ltd. v. HFH-USACorp.*, 805 F. Supp. 133, 135 (W.D.N.Y. 1992). *See also Fishback Nursery, Inc. v. PNC Bank, National Ass'n*., 920 F.3d 932, 938-39 (5th Cir. 2019) ("[a]nalysis of choice-of-law in lien priority disputes begins, not with section 188 [of the Restatement], but with the 'most significant relationship' test in section 6 [of the Restatement]. And the section 6 test is quite simple to apply where, as here, 'Texas … has a statute which specifically controls the choice of law issue.'").

But, the bedrock of this result is judge-made common law on conflicts-of-law rule selection — *i.e.*, should a court apply U.S. or foreign conflict of law rules. In a real way, this is what asset-based lenders to U.S. companies are banking on. Somewhat easily, a specific fact or legal interpretation could push a court to apply Section 187 of the Restatement instead of Section 6, which could spell serious trouble for the secured lender. Especially in a workout scenario, it is not difficult to think of reasons why courts could find a lender sufficiently involved in a key supply arrangement to deem that lender a "party" under Section 187 of the Restatement.

What should secured lenders do in light of all this? First and foremost, understand their strengths and weaknesses in the retention-of-title analysis. Then, lenders can judge whether certain foreign supply arrangements are

sufficiently critical to justify extra protections, such as an agreement between the vendor and lender that acknowledge what law applies between them.

What can foreign vendors do to protect themselves? The clearest answer is to file a UCC financing statement in respect of their retained title. This may not completely protect them, but it will go a long way. At a minimum, it should give secured lenders a reason to pause before advancing on the subject inventory — likely prompting an intercreditor discussion with the vendor.

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