

UNCITRAL Legislative Guide on Secured Transactions



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Legislative Guide on Secured Transactions



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Preface

The *UNCITRAL Legislative Guide on Secured Transactions* was prepared by the United Nations Commission on International Trade Law (UNCITRAL). At its thirty-third session, in 2000, the Commission considered a report of the Secretary-General on possible future work in the area of secured credit law (A/CN.9/475). At that session, the Commission agreed that the subject of security interests was important and had been brought to the attention of the Commission at the right time, in particular in view of the close link between security interests and the work of the Commission on insolvency law, and requested the Secretariat to prepare a further report.¹

At its thirty-fourth session, in 2001, the Commission considered a further report of the Secretary-General (A/CN.9/496). At that session, the Commission agreed that work on security interests should be undertaken in view of the beneficial economic impact of secured credit law and entrusted Working Group VI (Security Interests) with the task of developing an efficient legal regime for security interests in goods involved in a commercial activity, including inventory.² The Commission also recommended that a colloquium be held in view of the need to consult practitioners and organizations with expertise in the field of secured credit law.³ An international colloquium on secured transactions was held in Vienna from 20 to 22 March 2002. Working Group VI considered the report of the colloquium at its first session, which was held in New York from 2 to 24 May 2002.

At its thirty-fifth session, in 2002, the Commission confirmed that the mandate of the Working Group should be interpreted broadly to ensure an appropriately flexible work product, which should take the form of a legislative guide.⁴

Working Group VI considered the first draft of the guide on secured transactions in May 2002. The work of the Working Group was developed through 12 one-week sessions,⁵ the final session taking place in February 2007. In addition to representatives of the 60 States members of the Commission, representatives of many other States and a number of international organizations, both governmental and non-governmental, participated actively in the preparatory work. Working Group VI closely collaborated with Working Group V (Insolvency) in order to ensure coordination of the treatment of security interests in insolvency with the *UNCITRAL Legislative Guide on Insolvency Law*.⁶ In addition, Working Group VI closely cooperated with the Permanent Bureau of the Hague Conference on Private International Law in the preparation of the chapter on conflict of laws. Moreover, Working Group VI coordinated with the International Institute on Private International Law (Unidroit) to avoid overlap with the Convention on International Interests

¹*Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17)*, paras. 459 and 463.

²*Ibid.*, *Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3)*, paras. 351 and 358.

³*Ibid.*, para. 359.

⁴*Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, paras. 202-204.

⁵The reports of the Working Group on its work during these 12 sessions are contained in documents A/CN.9/512, A/CN.9/531, A/CN.9/532, A/CN.9/543, A/CN.9/549, A/CN.9/570, A/CN.9/574, A/CN.9/588, A/CN.9/593, A/CN.9/603, A/CN.9/617 and A/CN.9/620. During these sessions, the Working Group considered documents A/CN.9/WG.VI/WP.1-31. These reports of the Working Group were considered by the Commission from its thirty-fifth to fortieth sessions.

⁶United Nations publication, Sales No. E.05.V.10. The reports of the two joint sessions of Working Group V and Working Group VI are contained in documents A/CN.9/535 and A/CN.9/550. During these sessions, the working groups considered documents A/CN.9/WG.VI/WP.6/Add.5, A/CN.9/WG.V/WP.70 and A/CN.9/WG.V/WP.71.

in Mobile Equipment (Cape Town, 2001) and the Unidroit Convention on Substantive Rules for Intermediated Securities (Geneva, 2009).

At its thirty-ninth session, in 2006, the Commission considered and approved in principle the substance of the recommendations of the guide on secured transactions.⁷ The final negotiations on the draft legislative guide on secured transactions took place during the fortieth session of UNCITRAL, held in Vienna from 25 June to 12 July 2007 (first part)⁸ and from 10 to 14 December 2007 (second part), and the text was adopted by consensus on 14 December 2007 (see annex II. A).⁹ Subsequently, the General Assembly adopted resolution 63/121 of 11 December 2008 (see annex II.B). In this resolution, the General Assembly expressed its appreciation to UNCITRAL for the completion and adoption of the *UNCITRAL Legislative Guide on Secured Transactions*, requested the Secretary-General to broadly disseminate the *Guide* and recommended both the *Guide* and the United Nations Convention on the Assignment of Receivables in International Trade, the principles of which are also reflected in the *Guide*, to States.

⁷*Official Records of the General Assembly, Sixty-first Session, Supplement No. 17 (A/61/17)*, para. 13. The draft guide was contained in documents A/CN.9/WG.VI/WP.21/Add.3, A/CN.9/WG.VI/WP.24 and Add.5, A/CN.9/WG.VI/WP.26/Add.4-8 and A/CN.9/611 and Add.1 and 2.

⁸*Ibid.*, *Sixty-second Session, Supplement No. 17, (A/62/17 (Part I))*, para. 154. The draft guide was contained in documents A/CN.9/631 and Add.1-11.

⁹*Ibid.*, *Sixty-second Session, Supplement No. 17 (A/62/17, Part II)*, paras. 99 and 100. The draft guide was contained in documents A/CN.9/631/Add.1-3 and A/CN.9/637 and Add.1-8.

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Introduction

A. Purpose of the *Guide*

1. The purpose of the *UNCITRAL Legislative Guide on Secured Transactions* (hereinafter referred to as the “*Guide*”) is to assist States in developing modern secured transactions¹ laws (that is, laws related to transactions creating a security right in a movable asset) with a view to promoting the availability of secured credit. The *Guide* is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to modernize their laws and harmonize them with the laws of other States.

2. The *Guide* is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (in particular small and medium-sized enterprises) and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making consumer credit more readily available. In order to fully achieve their objectives, these laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (such as the insolvency law recommended in the *UNCITRAL Legislative Guide on Insolvency Law*; hereinafter referred to as the “*UNCITRAL Insolvency Guide*”).²

3. The *Guide* seeks to rise above differences among legal regimes to offer pragmatic and proven solutions that can be accepted and implemented in States with divergent legal traditions (civil law, common law, as well as Chinese, Islamic and other legal traditions) and in States with developing or developed economies. The focus of the *Guide* is on laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable, though limited, costs to implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

4. All businesses, whether engaged in mining, lumbering, agriculture, manufacturing, distributing, providing services or retailing, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (IBRD), the International Monetary Fund (IMF), the Asian Development Bank

¹Like many other terms and concepts in the *Guide*, the term “secured transaction” is explained in section B of the Introduction. The reader may, therefore, wish to refer to that section when reading the *Guide*.

²United Nations publication, Sales No. E.05.V.10. The impact of insolvency on security rights is addressed in chapter XII of the *Guide* in a comprehensive way that is consistent with the *UNCITRAL Insolvency Guide*. Thus, core recommendations from the *UNCITRAL Insolvency Guide* that relate particularly to security rights are included in chapter XII of this *Guide*, together with some additional recommendations elaborating on issues that are discussed in the *UNCITRAL Insolvency Guide* but are not the subject of recommendations in that *Guide*.

(ADB) and the European Bank for Reconstruction and Development (EBRD) that one of the most effective means of providing working capital to commercial enterprises is through secured credit.

5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing the creditor's risk that it will not be paid. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of recovery in the event of non-payment of the secured obligation. As prospective creditors perceive that this risk is reduced in a proposed credit transaction, they are more likely to be willing to extend credit and to increase the amount or reduce the cost of the credit they provide.

6. A legal system that supports secured transactions is critical to reducing the perceived risks of transactions and promoting the availability of secured credit generally. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for secured creditors in the event of non-performance by debtors. On the other hand, in States where the absence of such laws means that creditors perceive the risks associated with credit transactions to be high, the cost of credit normally increases, as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime or of an insolvency law regime, under which security rights are recognized, has resulted in the virtual elimination of credit for small and medium-sized commercial enterprises, as well as for consumers.

7. By aiding in the cultivation and growth of individual businesses, a legal regime that promotes secured credit can also have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves valuable economic benefits.

8. In order to best promote the availability of secured credit, the *Guide* suggests that secured transactions laws should be structured to enable businesses to maximize the extent to which they can utilize the value inherent in their movable assets to obtain credit. In this regard, the *Guide* adopts two of the most essential concepts of successful secured transactions laws. The first is the concept of effectiveness against third parties (as distinguished from the concept of effectiveness between the parties). An essential element of this concept is a simple mechanism to achieve third-party effectiveness through registration of a notice in a quick and inexpensive way. The second concept is the concept of priority. This concept allows for the concurrent existence of security rights having different priority status in the same assets. This makes it possible for a business to utilize the value of its assets to the maximum extent possible to obtain secured credit from more than one creditor using the same assets as security, while at the same time allowing each creditor to know the priority of its security right. These concepts are discussed in detail in chapters III and V of the *Guide*.

9. The legal regime envisaged in the *Guide* is a purely domestic regime. The *Guide* is addressed to national legislators considering reform of their domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different States, the *Guide* also seeks to address the recognition of security rights and title-based security devices (such as retention of title in and financial leases of tangible assets)

that have been effectively created in other States. This recognition would represent a marked improvement for the holders of those rights over the laws currently in effect in many States, under which such rights are often lost once an encumbered asset is transported across national borders, and would go far towards encouraging creditors to extend credit in cross-border transactions, a result that could enhance international trade.

10. Throughout, the *Guide* seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons (such as buyers and other transferees of encumbered assets) and the State. In so doing, the *Guide* adopts the premise, supported by substantial empirical evidence, that all creditors will accept such a balanced approach and will thereby be encouraged to extend credit, as long as the laws (and supporting legal and governmental infrastructure) enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately obtain the economic value of the encumbered assets in the event of non-payment or other non-performance by the debtor. Essential to this balance is a close coordination between the secured transactions law and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require further protection. Thus, although the regime envisioned by the *Guide* will apply to many forms of consumer transaction, it is not intended to override consumer-protection laws or to elaborate consumer-protection policies, since these matters are typically addressed in other legislation.

11. In the same spirit, the *Guide* also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. A second concern is the potential ability of a secured creditor to exercise undue influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. A third concern is that, in some cases, secured creditors may enforce their rights in most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, who may not be in a position to bargain for a security right in those assets. The *Guide* discusses these concerns and suggests balanced solutions in those situations where the concerns appear to have merit.

12. The *Guide* builds on the previous work of UNCITRAL and other organizations. Such work includes the Model Law on Secured Transactions, completed by the EBRD in 1994;³ the EBRD "Core principles for a secured transactions law", completed in 1997;⁴ the Organization for the Harmonization of Business Law in Africa's Uniform Act Organizing Securities, prepared in 1997;⁵ the studies on insolvency and secured transactions law reform in Asia, and the Guide to Movables Registries, prepared by ADB;⁶ the United Nations Convention on the Assignment of Receivables in International Trade, adopted in 2001

³Model Law on Secured Transactions, published by the European Bank for Reconstruction and Development in London in 1994.

⁴www.ebrd.com/country/sector/law/st/core/model/core.htm

⁵www.ohada.com/textes.php?categorie=458

⁶See Law and Policy Reform at the Asian Development Bank 2000, Volume I (April 2000), Law and Policy Reform at the Asian Development Bank 2000, Volume II (December 2000) and Law and Policy Reform at the Asian Development Bank — A Guide to Movables Registries (December 2002).

(hereinafter referred to as the “United Nations Assignment Convention”);⁷ the Convention on International Interests in Mobile Equipment, adopted in 2001, and the relevant protocols thereto;⁸ the Organization of American States (OAS) Model Inter-American Law on Secured Transactions, prepared in 2002;⁹ the UNCITRAL Insolvency Guide, completed in 2004;¹⁰ the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, adopted by the Hague Conference on Private International Law in 2002 (hereinafter referred to as “The Hague Securities Convention”);¹¹ and the Unidroit Convention on Substantive Rules for Intermediated Securities (Geneva, 2009).¹²

13. Section B, on terminology and interpretation, sets out principles behind the interpretation of terms used within the *Guide*. Key terms are presented in the glossary appearing at the beginning of the *Guide*, where the precise meaning attributed in the *Guide* to these terms is explained. Section C below offers an overview of the various types of financing practice that the *Guide* is meant to cover, as these are found in many States today. The objective is to illustrate the range of credit transactions to which the recommendations of the *Guide* are addressed. Section D below is devoted to setting out the key objectives and fundamental policies that underlie an effective and efficient secured transactions regime. The key objectives set out in section D.1 are drawn from reflection concerning the main goals of legislation on secured transactions, based on work done by other organizations and complemented by additional considerations arising from UNCITRAL’s own work on receivables financing and insolvency. In section D.2 below, a series of fundamental policies are presented that orient the recommendations of the *Guide*. These policies are described in order to highlight the key features of the *Guide* that may represent departures from the current law of many States and to provide a link between the general key objectives and the specific recommendations of the *Guide*.

14. Section E considers a number of issues relating to implementation of a new secured transactions law. Section E.2 addresses the question of how States can ensure that legislation enacted by following the recommendations of the *Guide* will be effectively integrated into the existing legal framework. Section E.3 discusses how the recommendations of the *Guide* may be implemented in a manner consistent with a variety of methods of legislative drafting, while section E.4 suggests a number of post-implementation steps that States may wish to adopt in order to ensure that a revised secured transactions law is effective in practice. The Introduction concludes with the *Guide*’s first recommendation, outlining the key objectives that States should pursue in enacting an efficient and effective secured transactions law.

B. Terminology and interpretation

15. The law of secured transactions lies at the crossroads of several branches of national law. Consequently, in order to ensure clarity and minimize misunderstanding, the *Guide*

⁷United Nations publication, Sales No. E.04.V.14.

⁸Cape Town Convention and Aircraft Protocol, Acts and Proceedings of the Cape Town Diplomatic Conference, 2006, International Institute for the Unification of Private Law (Unidroit), Rome.

⁹www.oas.org/dil/cidip-vi-securedtransactions_eng.htm

¹⁰See footnote 2 above.

¹¹Proceedings of the Nineteenth Session (2002), tome II, Securities, HCCH, 2006 and http://hcch-e-vision.ul/index_en.php?act=conventions.text&cid=72

¹²www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm

adopts precise terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a term appears to be the same as that found in a particular national law (whether secured transactions or any other law), the *Guide* does not intend to adopt the meaning of the term in that national law. Rather, in order to facilitate precise communication independent of any particular national legal system, the *Guide* offers a glossary of key terms used in the *Guide* (see below). This glossary is meant to enable readers of the *Guide* to understand its recommendations in a uniform way, providing them with a common vocabulary and conceptual framework. It is, therefore, an essential component of the *Guide*.

16. The scope and content of each recommendation depend on the meaning of its terms. When States enact a secured transactions law, it is important that, to the extent that the terms and concepts do not already form part of national law, they be fully defined. Some recommendations use terms that are specifically explained in those recommendations. The meaning of some of the terms listed below is further developed in recommendations that use those terms or in relevant chapters of the *Guide*. Ideally, States might simply incorporate these terms and concepts into the new law, changing nomenclature where necessary but maintaining the substance of the concepts. Alternatively, States may consider taking the meanings as set out in the *Guide* as the basis for elaborating definitions in a statute enacting the recommendations of the *Guide*. In both cases, this could help avoid unintended substantive changes, maximize uniform interpretation of the new statute and promote harmonization of secured transactions law.

17. In the recommendations of the *Guide*, the word “or” is not intended to be exclusive; use of the singular also includes the plural and vice versa; “include” and “including” are not intended to indicate an exhaustive list; “may” indicates permission and “should” indicates instruction; and “such as” and “for example” are to be interpreted in the same manner as “include” or “including”. “Creditors” should be interpreted as including both the creditors in the enacting State and foreign creditors, unless otherwise specified. References to “person” should be interpreted as including both natural and legal persons, unless otherwise specified. References to “property right” are to be interpreted as referring to a right in an asset (right *in rem*) as opposed to a personal right (right *ad personam*).

18. Some States may choose to implement the recommendations of the *Guide* by enacting a single comprehensive statute (a method more likely to produce coherence and avoid errors of omission or misunderstanding). Other States may seek to modify their existing body of law by insertion of specific rules in various statutes. The *Guide* refers to the entire body of recommended rules, whichever method is chosen for implementation, as “the law” or “this law”.

19. The *Guide* also uses the term “law” in various other contexts. Except when otherwise expressly provided, throughout the *Guide*: (a) all references to law refer to both statutory and non-statutory law; (b) all references to law refer to domestic law, excluding conflict-of-laws rules (so as to avoid renvoi); (c) all references to “other law” refer to the entire body of a State’s law (whether substantive or procedural) other than that embodying the law governing secured transactions (whether pre-existing or newly enacted or modified pursuant to the recommendations of the *Guide*); (d) all references to “the law governing negotiable instruments” refer not only to a special statute or body of law denominated as “negotiable instruments law” but include also all contract and other general law that

might be applicable to transactions or situations involving a negotiable instrument (the same rule applies to similar expressions); and (e) all references to “insolvency law” are similarly all-encompassing, but refer only to law that may be applicable to the commencement and conduct of insolvency proceedings.

20. The glossary below sets out the principal terms used and the core meaning given to them in the *Guide*. The meaning of the terms is further refined when they are used in various chapters. Those chapters also use and explain additional terms (as is the case, for example, with chapter XII on the impact of insolvency on a security right). These additional terms should be read together with the relevant recommendations. The principal terms of the *Guide* and their core meaning are as follows:

“Acknowledgement” with respect to a right to receive the proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a demand for payment (“draw”) under an independent undertaking has, unilaterally or by agreement:

(a) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the right to receive the proceeds under an independent undertaking; or

(b) Obligated itself to pay or otherwise give value to the secured creditor upon a draw under an independent undertaking;

“Acquisition secured creditor” (a term used in the context of both the unitary and the non-unitary approaches to acquisition financing) means a secured creditor that has an acquisition security right. In the context of the unitary approach, the term includes a retention-of-title seller or financial lessor (terms used in the context of the non-unitary approach);

“Acquisition security right” (a term used in the context of both the unitary and the non-unitary approaches to acquisition financing) means a security right in a tangible asset (other than a negotiable instrument or negotiable document) that secures the obligation to pay any unpaid portion of the purchase price of the asset or an obligation incurred or credit otherwise provided to enable the grantor to acquire the asset. An acquisition security right need not be denominated as such. Under the unitary approach, the term includes a right that is a retention-of-title right or a financial lease right (terms used in the context of the non-unitary approach);

“Assignee” means a person to which an assignment of a receivable is made;¹³

“Assignment” means the creation of a security right in a receivable that secures the payment or other performance of an obligation. While an assignment that is an outright transfer does not secure the payment or other performance of an obligation, for convenience of reference the term also includes an outright transfer of a receivable;¹⁴

¹³For the terms “assignee”, “assignor” and “assignment”, see also article 2, subparagraph (a), of the United Nations Assignment Convention.

¹⁴See the term “security right”, as well as recommendation 3 and the relevant commentary.

“Assignor” means a person that makes an assignment of a receivable;

“Attachment to a movable asset” means a tangible asset that is physically attached to another tangible asset but has not lost its separate identity;

“Attachment to immovable property” means a tangible asset that is so physically attached to immovable property that, despite the fact that it has not lost its separate identity, it is treated as immovable property under the law of the State where the immovable property is located;

“Bank account” means an account maintained by a bank, to which funds may be credited. The term includes a checking or other current account, as well as a savings or time deposit account. The term also includes a right to the payment of funds transferred to the bank by way of anticipatory reimbursement of a future payment obligation to which the bank has committed and a right to the payment of funds transferred to the bank by way of cash collateral securing an obligation owed to the bank to the extent that the transferor of those funds has a claim to them, if under national law the bank’s obligation is a bank account. The term does not include a right against the bank to payment evidenced by a negotiable instrument;

“Competing claimant”¹⁵ means a creditor of a grantor that is competing with another creditor of the grantor having a security right in an encumbered asset of the grantor and includes:

(a) Another creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);

(b) In the context of the non-unitary approach to acquisition financing, the seller or financial lessor of the same encumbered asset that has retained title to it;

(c) Another creditor of the grantor that has a right in the same encumbered asset;

(d) The insolvency representative in the insolvency proceedings in respect of the grantor;¹⁶ or

(e) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset;

“Confirmer” means a bank or other person that adds its own independent undertaking to that of a guarantor/issuer;¹⁷

“Consumer goods” means goods that a grantor uses or intends to use for personal, family or household purposes;

¹⁵For the term “competing claimant”, see also article 5, subparagraph (m), of the United Nations Assignment Convention.

¹⁶In the chapter on the impact of insolvency on a security right (chapter XII of this *Guide*), reference is made to “the insolvency of the debtor” for reasons of consistency with the terminology used in the UNCITRAL Insolvency Guide.

¹⁷In line with article 6, subparagraph (e), of the *United Nations Convention on Independent Guarantees and Stand-by Letters of Credit* (United Nations publication, Sales No. E.97.V.12), a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer.

“Control” with respect to a right to payment of funds credited to a bank account exists:

(a) Automatically upon the creation of the security right if the depositary bank is the secured creditor;

(b) If the depositary bank has concluded a control agreement with the grantor and the secured creditor; or

(c) If the secured creditor is the account holder;

“Control” with respect to a right to receive the proceeds under an independent undertaking exists:

(a) Automatically upon the creation of a security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or

(b) If the guarantor/issuer, confirmer or nominated person has made an acknowledgement in favour of the secured creditor;

“Control agreement” means an agreement between a depositary bank, a grantor and a secured creditor, evidenced by a signed writing,¹⁸ according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent from the grantor;

“Debtor” means a person that owes performance of a secured obligation and includes a secondary obligor such as a guarantor of a secured obligation. The debtor may or may not be the person that creates the security right (see the term “grantor” below);

“Debtor of the receivable” means a person liable for payment of a receivable and includes a guarantor or other person secondarily liable for payment of the receivable;¹⁹

“Encumbered asset” means a tangible or intangible asset that is subject to a security right. The term also includes a receivable that has been the subject of an outright transfer;²⁰

“Equipment” means a tangible asset used by a person in the operation of its business;

“Financial contract” means any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction,

¹⁸For the meaning of the term “signed writing” in the context of electronic communications, see recommendations 11 and 12.

¹⁹See also article 2, subparagraph (a), of the United Nations Assignment Convention. A guarantor in an accessory guarantee is not only a debtor of the receivable of which it has guaranteed the payment, but also a debtor of the receivable constituted by the guarantee, as an accessory guarantee is itself a receivable (that is, there are two receivables).

²⁰See the term “security right”, as well as recommendation 3 and the relevant commentary.

and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above;²¹

“Financial lease right” (a term used only in the context of the non-unitary approach to acquisition financing) means a lessor’s right in a tangible asset (other than a negotiable instrument or negotiable document) that is the object of a lease agreement under which, at the end of the lease:

(a) The lessee automatically becomes the owner of the asset that is the object of the lease;

(b) The lessee may acquire ownership of the asset by paying no more than a nominal price; or

(c) The asset has no more than a nominal residual value.

The term includes a hire-purchase agreement, even if not nominally referred to as a lease, provided that it meets the requirements of subparagraph (a), (b) or (c);

“Grantor” means a person that creates a security right to secure either its own obligation or that of another person.²² Under the unitary approach to acquisition financing, the term “grantor” of an acquisition security right includes a retention-of-title buyer or financial lessee. Although an assignor in an outright transfer of a receivable does not assign the receivable in order to secure the performance of an obligation, for convenience of reference the term also includes an assignor in an outright transfer of a receivable;²³

“Guarantor/issuer” means a bank or other person that issues an independent undertaking;

“Independent undertaking” means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (including a demand or first-demand bank guarantee, or a counter-guarantee) or any other undertaking recognized as independent by law or practice rules such as the United Nations Guarantee and Stand-by Convention, the Uniform Customs and Practice for Documentary Credits, the Rules on International Standby Practices and the Uniform Rules for Demand Guarantees;

“Insolvency court” means a judicial or other authority competent to control or supervise insolvency proceedings;

“Insolvency estate” means the assets of a debtor that are subject to insolvency proceedings;

²¹See article 5, subparagraph (k), of the United Nations Assignment Convention; see also the relevant term in the UNCITRAL Insolvency Guide. The reference in this term to “any other transaction similar to any transaction referred to above entered into in financial markets” is intended to include the full range of transactions entered into in financial markets. The term is flexible. It includes any transaction entered into in financial markets under which payment rights are determined by reference to: (a) underlying asset classes; or (b) quantitative measures of economic or financial risk or value associated with an occurrence or contingency. Examples are transactions under which payment rights are determined by reference to weather statistics, freight rates, emissions allowances or economic statistics.

²²See the term “debtor”.

²³See the term “security right”, as well as recommendation 3 and the relevant commentary.

“Insolvency proceedings” means collective proceedings, subject to insolvency court supervision, either for reorganization or liquidation;

“Insolvency representative” means a person or body, including one appointed on an interim basis, authorized in insolvency proceedings to administer the reorganization or the liquidation of the insolvency estate;

“Intangible asset” means all types of movable assets other than tangible assets and includes incorporeal rights, receivables and rights to the performance of obligations other than receivables;

“Intellectual property” means copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset considered to be intellectual property under the domestic law of the enacting State or under an international agreement to which the enacting State is a party;²⁴

“Inventory” means tangible assets held for sale or lease in the ordinary course of a person’s business, as well as raw and semi-processed materials (work-in-process);

“Issuer” of a negotiable document means the person that is obligated to deliver the tangible assets covered by the document under the law governing negotiable documents, whether or not that person has agreed to perform all obligations arising from the document;

“Knowledge” means actual rather than constructive knowledge;

“Mass or product” means tangible assets other than money that are so physically associated or united with other tangible assets that they have lost their separate identity;

“Money” means currency currently authorized as legal tender by any State. It does not include funds credited to a bank account or negotiable instruments such as cheques;

“Negotiable document” means a document, such as a warehouse receipt or a bill of lading, that embodies a right to delivery of tangible assets and satisfies the requirements for negotiability under the law governing negotiable documents;

²⁴The term “intellectual property” is intended to ensure consistency of the *Guide* with intellectual property laws and treaties, while at the same time respecting the right of legislators in a State enacting the recommendations of the *Guide* to align the meaning of the term with that State’s own law and international obligations. An enacting State may add to this list or remove from it types of intellectual property to conform it to national law. The reference to international agreements is intended to refer to agreements such as the Convention Establishing the World Intellectual Property Organization and the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS”). In order to clarify that these terms and the recommendations referring to them apply only to tangible assets (and not to intangible assets such as intellectual property), reference is made to “tangible assets” in the terms “acquisition security right”, “retention-of-title right” and “financial lease right”. In the term “receivable”, no reference is made to “the performance of non-monetary obligations” in order to clarify the understanding that the term and the recommendations relating to receivables apply only to receivables and not, for example, to the rights of a licensee or the obligations of a licensor under a contractual license of intellectual property.

“Negotiable instrument” means an instrument, such as a cheque, bill of exchange or promissory note, that embodies a right to payment and satisfies the requirements for negotiability under the law governing negotiable instruments;²⁵

“Netting agreement” means an agreement between two or more parties that provides for one or more of the following:

(a) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;

(b) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market value, conversion of such sums into a single currency and netting into a single payment by one party to the other; or

(c) The set-off of amounts calculated as set forth in subparagraph (b) under two or more netting agreements;²⁶

“Nominated person” means a bank or other person that is identified in an independent undertaking by name or type (for example, “any bank in country X”) as being nominated to give value under an independent undertaking and that acts pursuant to that nomination and, in the case of a freely available independent undertaking, any bank or other person;

“Notice” means a communication in writing;²⁷

“Notification of the assignment” means a communication in writing that reasonably identifies the assigned receivable and the assignee;²⁸

“Original contract” means, in the context of a receivable created by contract, the contract between the assignor and the debtor of the receivable from which the receivable arises;

“Possession” (except as the term is used in recommendations 28 and 51-53, with respect to the issuer of a negotiable document) means only the actual possession of a tangible asset by a person or an agent or employee of that person, or by an independent person that acknowledges holding it for that person. It does not include non-actual possession described by terms such as constructive, fictive, deemed or symbolic possession;

“Priority” means the right of a person to derive the economic benefit of its security right in preference to the right of a competing claimant;

“Proceeds” means whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or

²⁵The *Guide* was prepared against the background of negotiable instruments and negotiable documents in paper form, in view of the particular difficulty of creating an electronic equivalent of paper-based negotiability. However, the *Guide* should not be interpreted as discouraging the use of electronic equivalents of paper negotiable instruments or negotiable documents. Thus, an enacting State that wishes to address this matter will need to devise special rules. For the same reason, the *United Nations Convention on the Use of Electronic Communications in International Contracts* does not address the electronic equivalent of paper-based negotiability (see United Nations publication, Sales No. E.07.V.2, explanatory note, para. 7).

²⁶See also article 5, subparagraph (1), of the United Nations Assignment Convention.

²⁷For the electronic equivalents of the terms “writing” and “signed writing”, see recommendations 11 and 12.

²⁸As to when notification of the assignment is effective, see recommendation 118.

licence of an encumbered asset, proceeds of proceeds, natural and civil fruits or revenues, dividends, distributions, insurance proceeds and claims arising from defects in, damage to or loss of an encumbered asset;²⁹

“Receivable” means a right to payment of a monetary obligation, excluding a right to payment evidenced by a negotiable instrument, a right to receive the proceeds under an independent undertaking and a right to payment of funds credited to a bank account;³⁰

“Retention-of-title right” (a term used only in the context of the non-unitary approach to acquisition financing) means a seller’s right in a tangible asset (other than a negotiable instrument or a negotiable document) pursuant to an arrangement with the buyer by which ownership of the asset is not transferred (or is not transferred irrevocably) from the seller to the buyer until the unpaid portion of the purchase price is paid;

“Right to receive the proceeds under an independent undertaking” means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be paid or delivered by the guarantor/issuer, confirmer or nominated person giving value for a draw under an independent undertaking. The term also includes the right to receive payment in connection with the purchase by a negotiating bank of a negotiable instrument or a document under a complying presentation. The term does not include:

- (a) The right to draw under an independent undertaking; or
- (b) What is received upon honour of an independent undertaking;³¹

“Secured creditor” means a creditor that has a security right. Although an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference the term also includes the assignee in an outright transfer of a receivable;³²

“Secured obligation” means an obligation secured by a security right;

“Secured transaction” means a transaction that creates a security right. Although an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference the term also includes an outright transfer of a receivable;³³

²⁹See article 5, subparagraph (j), of the United Nations Assignment Convention.

³⁰See article 2, subparagraph (a), of the United Nations Assignment Convention. It should be noted that, while the Convention applies only to contractual receivables, the Guide applies to non-contractual receivables as well (see chapter I on scope, para. 6); for the exclusion of bank deposits, letters of credit and negotiable instruments, see article 4, subparagraphs 2 (f) and 2 (g), and paragraph 3, respectively, of the United Nations Assignment Convention.

³¹A security right in the right to receive the proceeds under an independent undertaking (as an original encumbered asset) is different from a security right in “proceeds” (a key concept of the *Guide* of assets covered in the *Guide* (see the term “proceeds” and recommendation 19). Thus, what is received upon honour of (that is, as a result of a complying presentation under) an independent undertaking constitutes the “proceeds” of the right to receive the proceeds under an independent undertaking.

³²See the term “security right”, as well as recommendation 3 and the relevant commentary.

³³*Ibid.*

“Security agreement” means an agreement, in whatever form or terminology, between a grantor and a creditor that creates a security right. Although an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference the term also includes an agreement for the outright transfer of a receivable;³⁴

“Security right” means a property right in a movable asset that is created by agreement and secures payment or other performance of an obligation, regardless of whether the parties have denominated it as a security right. In the context of the unitary approach to acquisition financing, the term includes both acquisition security rights and non-acquisition security rights. In the context of the non-unitary approach to acquisition financing, it does not include a retention-of-title or financial lease right. Although an outright transfer of a receivable does not secure payment or other performance of an obligation, for convenience of reference the term also includes the right of the assignee in an outright transfer of a receivable.³⁵ The term does not include a personal right against a guarantor or other person liable for the payment of the secured obligation;

“Subsequent assignment” means an assignment by the initial or any other assignee.³⁶ In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee;

“Tangible asset” means every form of corporeal movable asset. Among the categories of tangible asset are inventory, equipment, consumer goods, attachments, negotiable instruments, negotiable documents and money.

C. Examples of financing practices covered in the *Guide*

21. A wide array of secured transactions is currently in use throughout the world. Some are expressly characterized in national law as secured transactions, while others are not. In order to provide a broad overview of the range of situations where secured credit can be found and of the financing practices that the *Guide* is designed to encourage, a variety of practices is described below. In a number of instances, the *Guide* refers to these examples to illustrate specific points that an efficient and effective secured transactions regime must address. It is important to note, however, that these examples represent only a few of the numerous forms of secured transaction currently in use. A modern secured transactions regime must be sufficiently flexible to accommodate existing methods of financing and to embrace new methods that inevitably will evolve in the future.

1. *Inventory and equipment acquisition financing*

22. Businesses often obtain financing for specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the inventory or equipment being purchased. In other cases, the financing is provided by a lender. Sometimes the lender is

³⁴Ibid.

³⁵See chapter I, recommendation 3, and the relevant commentary.

³⁶See article 2, subparagraph (b), of the United Nations Assignment Convention.

an independent third party, but in other cases the lender may be an affiliate of the seller (a finance company created by the seller to encourage and facilitate sales). The seller retains title to the inventory or equipment to secure the payment of the purchase price. Alternatively, the seller is granted a security right in the inventory or equipment that has been purchased to secure the repayment of the credit or loan.

23. Here is an illustration of acquisition financing. The example involves a company, ABC Manufacturing Company (ABC), three different vendors (V1, V2 and V3), an equipment lessor (L1) and a financing lender (FL1). ABC, a manufacturer of furniture, wishes to acquire certain inventory and equipment for use in its manufacturing operations. ABC desires to purchase paint (that is, a raw material, and, therefore, inventory) from vendor V1. ABC also wishes to purchase certain drill presses (that is, equipment) from vendor V2 and certain conveyors (also equipment) from vendor V3. Finally, ABC wishes to lease certain computer equipment from lessor L1.

24. Under the purchase agreement with vendor V1, ABC is required to pay the purchase price for the paint within 30 days of vendor V1's invoice to ABC and ABC grants to vendor V1 a security right in the paint to secure the payment of the purchase price. Under the purchase agreement with vendor V2, ABC is required to pay the purchase price for the drill presses within 60 days following their delivery to ABC's plant. The agreement also provides that until the purchase price is paid in full V2 retains title to the drill presses.

25. Under the purchase agreement with vendor V3, ABC is required to pay the purchase price for the conveyor equipment when it is installed in ABC's plant and rendered operational. ABC obtains a loan from lender FL2 to finance the purchase and installation of the conveyor equipment from vendor V3, secured by a security right in the conveyor equipment.

26. Under the lease agreement with lessor L1, ABC leases the computer equipment for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. The lease agreement provides that lessor L1 retains title to the equipment during the lease term, but that title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a "financial lease" or a "finance lease". Under some forms of financial lease, title to the leased asset is transferred to the lessee automatically at the end of the lease term. A financial lease is to be distinguished from what is usually called an "operating lease". Under an operating lease, the leased asset is expected to have a useful life remaining at the end of the lease term and the lessee does not have an option to purchase the leased asset at the end of the lease term for a nominal price, nor is title to the leased asset transferred to the lessee automatically at the end of the lease term.

27. In each of the above four cases (paint, drill presses, conveyors and computers), the acquisitions are made possible by means of acquisition financing provided by another entity (seller, lender or financial lessor) which holds rights in the acquired assets for the purpose of securing the acquisition financing that has been granted.

2. *Inventory and receivable revolving loan financing*

28. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can commence operations and sell its products, it must equip a plant, purchase raw materials, incur labour costs to convert the raw materials into finished products and sell the finished products. Only then will it generate receivables and begin to collect payments. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections. Moreover, this need is not limited to the business's initial start-up period. Rather, the need for working capital to address the gaps of time inherent in a business's cash conversion cycle (acquiring inventory, processing inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again) usually continues during the entire life of the business.

29. One highly effective method of providing such working capital is a revolving loan facility. Under this type of credit facility, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs. The borrower typically requests loans when it needs to purchase raw materials for the manufacture of inventory and repays the loans as the inventory is sold, receivables are generated and the receivables are collected. Thus, borrowings and repayments tend to be frequent (although not necessarily regular) and the amount of the credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle, this type of loan structure is, from an economic standpoint, highly efficient and beneficial to the borrower in that it helps the borrower to avoid borrowing more than it actually needs (thereby minimizing interest costs).

30. An illustration of this type of financing follows. It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender FL2 agrees to provide a revolving loan facility to ABC to finance this process. Under the loan facility, ABC may obtain loans from time to time according to a formula. It may borrow an amount of up to 50 per cent of the value of its inventory that lender FL2 deems to be acceptable for borrowing (based, for example, upon the type and quality of the inventory) and of up to 80 per cent of the value of its receivables that lender FL2 deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the debtors of the receivables). The amounts that the lender is willing to loan against the value of eligible inventory and receivables are commonly called the advance rates. The aggregate value of eligible inventory and receivables at any given time multiplied by the applicable advance rates is commonly called the borrowing base. ABC is expected to repay these loans from time to time as it receives payments of receivables from its customers, so that the outstanding loan balance under the facility at no time exceeds the borrowing base. The loan facility is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the right to payment of funds credited to the bank account into which customer payments (that is, the proceeds of inventory and receivables) are deposited and an agreement from the depositary bank to transfer funds credited to the account to the lender on a periodic basis.

3. Factoring

31. Factoring is a highly effective form of receivables financing that can trace its roots back many centuries. In general, factoring involves the outright sale or assignment of receivables by the grantor as seller (commonly called the assignor) to the factor (commonly called the assignee). Such an outright transfer of receivables is covered in the *Guide* even though it is not a security device (see chapter I, paras. 25-31).

32. There are a number of different types of factoring arrangement. The factor (assignee) may pay a portion of the purchase price for the receivables at the time of the purchase (discount factoring), it may pay only when the receivables are collected (collection factoring), or it may pay on the average maturity date of all of the receivables (maturity factoring). The factoring may be on a recourse or a non-recourse basis. Under a recourse factoring arrangement, the assignee of the receivables has recourse against the assignor to obtain payment in the event of non-payment by the debtors of the receivables (that is, the customers of the assignor). By contrast, under a non-recourse factoring arrangement, the assignee has no ability to obtain payment from the assignor if the debtors of the receivables fail to pay. Finally, the debtors of the receivables may be notified that their receivables have been the subject of factoring (notification factoring), or they may not be so notified (non-notification factoring). When notice is given to the customers, it is often accomplished by requiring the assignor to make a note on the invoices that the assignor sends to its customers.

33. While a factoring agreement is fundamentally a financing arrangement under which a business can obtain immediate cash for the receivables it generates, the factor may also perform various other services for the assignor relating to the receivables. These additional services may include approving and evaluating the creditworthiness of the debtors of the receivables, performing bookkeeping duties and engaging in collection efforts with respect to receivables that are not paid when due. These services can provide a useful benefit to companies that do not have their own credit and collection departments.

34. Here is an illustration of a typical factoring arrangement. ABC enters into a discount factoring arrangement with factor F1, pursuant to which factor F1 agrees to purchase receivables that it deems to be creditworthy. Factor F1 advances to ABC an amount equal to 90 per cent of the face value of those receivables, holding the remaining 10 per cent as monetary allowances to cover potential customer claims that would reduce the value of the receivables. The factoring arrangement is with notification to ABC's customers and is without recourse to ABC in the event of non-payment by ABC's customers.

4. Securitization

35. Another form of financing involving the use of receivables is securitization. Securitization is a sophisticated form of financing under which a business can obtain financing based on the value of its receivables by transferring them to a special purpose vehicle that is wholly owned by the business. The special purpose vehicle will then issue securities in the capital markets secured by the stream of income generated by the receivables. For example, this technique is commonly used in situations where a company's receivables consist of credit card receivables, motor vehicle rents or home mortgage loan payments,

although the securitization of many other types of receivable is also possible. Securitization transactions are complex financing transactions that are dependent upon both a jurisdiction's securities laws and its secured transactions laws. Where these transactions are sufficiently large, carefully structured and properly monitored, securitization can be a cost-effective form of financing.

36. Securitization is intended to lower the cost of financing because the special purpose vehicle is structured in such a way as to make the risk of its insolvency remote (theoretically not possible) by restricting the amount of debt that the special purpose vehicle can incur and the activities in which it can engage. This structure may significantly reduce the risk that the lender has to take into account when deciding what interest rate to charge for the loan. In addition, because the source of credit is the capital markets rather than the banking system, securitization can generate greater amounts of credit at lower cost than normal bank loans.

37. Here is an illustration of a securitization transaction. A special purpose vehicle is created by a large retail chain to purchase receivables arising from the use by its customers of the retailer's "private-label" or "in-house" credit card (that is, a credit card issued by the retailer and bearing the retailer's name). The special purpose vehicle then issues debt securities, under applicable securities laws, to investors in the capital markets. These debt securities are secured by the income stream flowing from the credit card receivables that have been transferred to the special purpose vehicle. As payments are made under the receivables, the special purpose vehicle will use the proceeds it receives to make payments on the debt securities.

5. *Term-loan financing*

38. Enterprises often need specific financing for large expenditures that are not in the ordinary course of their business. These expenditures may include, for example, the purchase or lease of significant items of equipment, the development of a new product line, or even the acquisition of another business through a purchase of the outstanding shares or the assets of that business. In these situations, enterprises generally seek loans that are repayable over a fixed period of time, with principal being repaid in monthly, quarterly or other periodic instalments pursuant to an agreed schedule or in a single payment at the end of the loan term.

39. As is the case with many other types of financing, an enterprise that does not have strong, well-established credit ratings will have difficulty obtaining term-loan financing unless it is able to grant a security right in its assets in favour of a lender. The amount of the financing available and its cost to the borrower will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered with the security right. In many States, immovable property is the only type of asset that is available to, or accepted by, lenders to secure term-loan financing. However, many enterprises, in particular newly established enterprises, do not own any immovable property. As a result, in these States term-loan financing is often not available to borrowers that may, nonetheless, have significant assets, such as equipment or the overall value of the entire enterprise. By contrast, in various other States, term loans secured by movable assets, such as equipment, intellectual property and the overall value of the enterprise, are common.

40. Here is an illustration of this type of financing. ABC desires to expand its operations and purchase a company. ABC obtains a loan (predicated on the value, and secured by substantially all of the assets, of the company being acquired) from lender FL3 to finance the acquisition. The loan is repayable in equal monthly instalments over a period of 10 years and is secured by all existing and future assets of both ABC and the company being acquired.

6. Credit secured by a transfer of title

41. The examples given in previous sections reveal how businesses in need of credit may obtain loans and other financing by offering creditors a security right in assets such as equipment, inventory and receivables. Both the type of credit offered and the type of security right granted can take many forms. One type of financing practice found in many States involves a transfer of title from the borrower to the lender. These types of transfer of title by way of security (sometimes known as a fiduciary transfer of title) are often used both to secure operating lines of credit and to secure term loans. They are primarily found in States where the secured transactions law does not generally recognize non-possessory security rights.

42. A “sale and lease-back” transaction is another method by which a company can obtain credit based upon its existing tangible assets (usually equipment) while still retaining possession of and the right to use these assets in the operation of its business. In a sale and leaseback transaction, the company will sell its assets to another person for a specific sum (which the company may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement. Often, the lease is a “financial lease” as opposed to an “operating lease” (see para. 20 above).

D. Key objectives and fundamental policies of an effective and efficient secured transactions regime

1. General

43. In enacting legislation to achieve effective and efficient secured transactions regimes, States face a number of fundamental policy choices. Some of these policy choices relate to the scope of the proposed law, some relate to the basic approaches to be taken, some relate to the style of expression of the law and some relate to the place the law is meant to occupy within a State’s existing legal framework. Perhaps the most significant choices, however, relate to the objectives that are meant to be pursued by the new law.

44. Over the years, States have used secured transactions law or, more generally, the law of security in movable assets to advance an array of often-conflicting social and economic policies. The regimes they have enacted, or have permitted to develop by practice and judicial decision, have typically achieved a reconciliation of these various goals in an ad hoc way. Occasionally, these regimes have done so effectively, but often they contain

inconsistent or contradictory elements that undermine their effectiveness. Likewise, in many States reformed secured transactions regimes permit the expansion of secured credit, but do so in inefficient ways that do not really advance all the social and economic policies States seek to pursue. These problems of ineffectiveness and inefficiency are frequently as much a part of the law of States with mature commercial economies as the law of States that are in the process of developing such economies. They are also present even in the law of some States that have only recently amended their secured transactions regimes.

45. In the spirit of providing practical, workable recommendations for all States, regardless of the character of their economy and legal system (or whether they have amended their laws recently), the *Guide* begins with a discussion of the key objectives that should inform the design of an efficient and effective secured transactions regime and of the fundamental policies upon which the regime should rest.

2. Key objectives

46. To place the key objectives that follow within a broader policy framework that States may pursue in modernizing their law, it is helpful to recall the basic premise of and justification for secured transactions law. Contemporary economies involve the manufacture and sale of movable assets and the provision of services, both domestically and internationally. As discussed in section C above, many businesses typically are not able to meet all their ongoing financial requirements in cash. The availability of credit and especially the availability of credit at the lowest possible cost are, consequently, fundamental to the growth of the economy. Lenders and other providers of credit are able to bridge the gap between needs and available resources most effectively when the risk of non-repayment of the credit they extend is reduced as much as possible. A security right in movable assets (as well as in immovable property) of a debtor can be a key element in reducing this risk. This is because a security right enables a provider of credit to rely on the value inherent in the encumbered assets as an alternative source of repayment of the credit. In other words, the grant of a security right permits businesses and individuals to gain access to credit in situations where unsecured credit would not be available at a reasonable cost or would not be available at all. The fundamental justification for secured transactions law lies in the premise that the total net wealth of an economy will increase if more secured credit is available as a complement to unsecured credit.

47. The key objectives discussed in this section draw on and further develop objectives identified in studies and reports produced by EBRD, ADB, IBRD, IMF, OAS and other organizations that have examined the law of secured transactions (see para. 12 above). These objectives are intended to provide a broad policy framework for legislatures seeking to enact a workable secured transactions regime. They are also meant to guide the interpretation of the law as enacted (in line with the approach followed, for example, in article 7, paragraph 1, of the United Nations Assignment Convention). Depending on the legislative drafting practices of enacting States, these objectives could be set out in an official statement at the time of enactment or in an accompanying interpretation text or commentary or included in the enactment itself, either as a preamble or similar introductory section setting out the purposes of the law.

48. Each of these objectives addresses a specific practical or economic need that must be met by a modern secured transactions regime. Together, they provide an integrated and coherent framework to guide the design and drafting of the law. Thus, it is important for States not just to choose selectively among these objectives, but also to take all of them into account to the fullest extent possible.

(a) To promote low-cost credit by enhancing the availability of secured credit

49. The primary objective of the *Guide* is to promote credit at a reasonable cost by enhancing the availability of secured credit. The aim is to enable debtors and the economy as a whole to obtain the economic benefits that flow from access to such credit. The benefits of the regime should, consequently, be extended to as many different types of debtor, creditor and credit transaction as possible.

(b) To allow debtors to use the full value inherent in their assets to support credit

50. In furtherance of the primary objective described in the preceding paragraph, the law should enable debtors to utilize the full value inherent in their assets to obtain credit. In order to achieve this objective, the regime should be as comprehensive as possible. This means that the law should apply to all types of debtor (that is, legal or natural persons, including consumers). In addition, achieving this objective entails permitting a broad range of assets (including tangible and intangible assets, as well as present and future assets) to serve as encumbered assets. Moreover, it entails permitting the widest possible array of obligations (including future, conditional, monetary and non-monetary obligations) to be secured by security rights in encumbered assets. It also means permitting the granting of security rights in the same assets by the same grantor to different credit providers.

(c) To enable parties to obtain security rights in a simple and efficient manner

51. The cost of secured credit depends in part on the cost associated with obtaining security rights. An efficient secured transactions regime will establish streamlined procedures for obtaining security rights. Transaction costs will be reduced notably by: minimizing formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different types of encumbered asset; and providing a mechanism that permits the creation of security rights in future assets and securing future advances of credit without the need for any additional documentation or action by the parties.

(d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transaction

52. Open competition among all potential credit providers is an effective way of reducing the cost of credit. For this reason, an efficient secured transactions regime will be designed to apply equally to a wide range of credit providers: financial institutions and other lenders, manufacturers and suppliers and both domestic and non-domestic credit providers.

(e) To validate non-possessory security rights in all types of asset

53. The granting of a security right should not make it difficult or impossible for the grantor of the security right to continue to operate its business. This means that the grantor should not be required to give up possession of the encumbered assets to the secured creditor. Thus, a modern secured transactions regime should provide for non-possessory security rights in a broad range of tangible and intangible assets, including equipment, inventory and receivables.

(f) To enhance certainty and transparency by providing for registration of a notice in a general security rights registry

54. In order for a secured transactions regime to function efficiently, it is important that all parties be able to determine with a reasonable degree of certainty the extent of the rights of a grantor and third parties in assets to be encumbered. The cornerstone for achieving this certainty, while at the same time respecting and addressing confidentiality concerns, is to establish a general security rights registry for recording notices about the possible existence of a security right. Such a registration system requires neither the submission of full documents for verification, nor their actual registration. Registry records would be made available for inspection by all interested parties.

(g) To establish clear and predictable priority rules

55. A prospective creditor must not only be able to ascertain the rights of the grantor and third parties in the assets to be encumbered, it must also be able to determine with certainty, at the time it agrees to extend credit, the priority that its security right in encumbered assets would enjoy relative to the rights of other creditors (including an insolvency representative in the grantor's insolvency). Thus, a modern secured transaction regime must provide clear rules that allow prospective creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

(h) To facilitate efficient enforcement of a secured creditors' rights

56. A security right will also have little value to a secured creditor unless it can be enforced effectively and efficiently. A modern secured transactions regime will include procedures that precisely describe the rights and obligations of grantors and secured creditors upon enforcement. The regime will allow secured creditors to enforce their security rights out of court, subject to judicial or other official control, supervision or review of the enforcement process when appropriate. Such a regime also requires a close coordination between a State's secured transactions law and its insolvency law, so that the pre-insolvency effectiveness and priority, as well as the economic value, of a security right will be respected in the grantor's insolvency, subject to the appropriate rules of insolvency law.

(i) To allow parties maximum flexibility to negotiate the terms of their security agreement

57. The goals and purposes being pursued by debtors and creditors in modern economies are extremely diverse and are often specific to particular parties. The secured

transactions regime should provide maximum flexibility for parties to tailor their security agreements to meet their precise needs. Mandatory rules governing their respective rights prior to default should be kept to a minimum. At the same time, where States enact other legislation aimed at, for example, consumer protection, the secured transactions regime should respect such legislation.

(j) *To balance the interests of persons affected by a secured transaction*

58. Security agreements are not just contractual undertakings between secured creditors and grantors. Their property effects also affect the rights of third parties such as other secured creditors, privileged and unsecured creditors, purchasers and other transferees of the encumbered assets, the insolvency representative and the State. An efficient and effective secured transactions regime must take into account the legitimate interests of all parties and aim to achieve each of the substantive objectives mentioned above, in a way that is balanced and consistent with relevant laws, including insolvency laws.

(k) *To harmonize secured transactions laws, including conflict-of-laws rules*

59. Increasingly, business is becoming international in scope and credit is flowing across national borders. A State's secured transactions regime will be most effective in promoting international trade based on equality of and mutual benefit to States when it is harmonized with regimes in other States. Furthermore, to the extent complete harmonization of national secured transactions laws might not be achieved, harmonization of conflict-of-laws rules will promote the financing of international trade. In any event, even if substantive law is harmonized between two States, workable conflict-of-laws rules are needed to provide clear guidance about how to make security rights effective against third parties, whether under the law of the location of the encumbered assets, the law of the location of the grantor or other law.

3. *Fundamental policies*

60. The key objectives just reviewed provide a general framework within which States can establish a modern secured transactions regime. There are, however, various ways of enacting these objectives into law. The recommendations of the *Guide* provide a detailed statement of the legal rules that States should incorporate into their legislation. The *Guide* is organized to address separately the various aspects of a secured transaction (for example, creation, third-party effectiveness, priority and enforcement). Despite their number, the recommendations set out in each chapter are all derived from a small number of fundamental legal policies. Some of these represent a significant departure from basic principles that are currently reflected in the secured transactions law of many States. Therefore, in order to provide a link between the key policy objectives discussed above and the more detailed recommendations set out in each chapter of the *Guide* as to the specific features of a modern secured transactions regime, these few fundamental legal policies are presented in the following paragraphs.

(a) *Comprehensive scope*

61. The *Guide* is based on the premise that secured credit is promoted when restrictions concerning who may be a grantor or a secured creditor, what types of asset may be encumbered and what kinds of obligation may be secured are minimized. Thus, States should aim at enacting legislation that is comprehensive in scope and that, as far as possible, embraces all forms of secured transactions, all categories of grantors and secured creditors and all types of movable asset and secured obligation. The principle of comprehensiveness of scope and the means for achieving it are explained more fully in chapter I.

(b) *Functional, integrated and comprehensive approach*

62. Many States have secured transactions regimes that permit grantors (especially companies) to offer security to creditors based upon all (or substantially all) of their assets. Nonetheless, in many of these States different legislative regimes govern different types of asset. Moreover, in many of these States different legislative regimes govern different types of transaction, such as pledges, mortgages, fiduciary transfers and hypothecs. Finally, in many States, the rights of sellers are treated differently from the rights of other providers of credit and are often not considered to be security rights at all. In contrast to this diversity, the *Guide* adopts what might be characterized as an integrated and functional approach. It takes the position that, to the maximum extent possible, all transactions that create a right in any type of asset meant to secure the performance of an obligation (that is, to fulfil security functions) should be considered to be secured transactions and regulated by the same rules or, at least, by the same principles. The integrated and functional approach is explained more fully in chapter I (see paras. 110-112) and, with respect to the special transactions of acquisition financing, in chapter IX (see paras. 60-84).

(c) *Security rights in future assets of a grantor*

63. Many States only permit grantors to create security rights in assets that are in existence and that they own at the time the security right is created. They are not able to grant security in assets not yet in existence or that they have not yet acquired. The concern underlying this restriction is to protect debtors from over-committing their assets, in particular their future assets, to one secured creditor. Nonetheless, because businesses may not always have available existing assets to secure credit, this limitation prevents them from obtaining many types of credit that are predicated upon a stream of future assets, such as inventory and receivables. Thus, the *Guide* adopts the view that, except to the extent that consumer protection legislation provides otherwise, a security right may be created in future assets. This principle is explained more fully in chapter I.

(d) *Extension of a security right into proceeds*

64. Usually, a non-possessory security right in tangible movable assets is accompanied by a right to follow the asset into the hands of a transferee. When the grantor sells or otherwise disposes of the asset, the buyer acquires the asset subject to the security right.

Some States also give the secured creditor a right in any asset (normally receivables) that may be generated by the sale of the encumbered asset. The *Guide* characterizes such assets as proceeds and takes the position that, because the economic value of the encumbered asset is the creditor's ultimate source of payment, the security right should be extended into whatever proceeds are received upon the disposition of the encumbered asset. The principle of extension of a security right into proceeds and the characteristics of this right are dealt with more fully in chapter II.

(e) *Distinguishing effectiveness as between the parties from effectiveness against third parties*

65. In many States, when a security right is created, it is effective not only between the grantor and the secured creditor but also against third parties. Sometimes this provides insufficient notice to third parties. As a result, States often impose additional formalities for the creation of the security right (even as between the grantor and secured creditor) that go well beyond what is normally required for contracting. This means that a secured creditor must always await the conclusion of the agreement with a grantor before taking steps to ensure the priority of its security right as against competing claimants. For these reasons, the *Guide* takes the position that a distinction should be drawn between creation of a security right (effectiveness as between the parties) and effectiveness as against third parties. The *Guide* also takes the position that creation of a security right should be as simple as possible and that only minimal additional steps should be required to make the security right effective against third parties. Creation (effectiveness as between the parties) and third-party effectiveness of a security right are discussed in chapters II and III, respectively.

(f) *Establishment of a general security rights registry*

66. Over the years, many States have abandoned the rule prohibiting the creation of non-possessory security rights in movable assets. In several of these States, however, only certain types of asset may be encumbered by non-possessory security rights and only certain types of grantor may grant non-possessory security rights. These States usually establish separate mechanisms to provide for publicity for different categories of assets, grantors or secured transactions. The *Guide* is premised on the view that efficiency will be enhanced if a State establishes a registry with the following central features: (a) it is a single general security rights registry; (b) it records notices relating to existing or potential security rights and not documents; (c) the registry files are made available for searching by any interested party; and (d) except in very limited cases (see chapter IX on acquisition financing), it provides that third-party effectiveness and priority are determined according to the time of registration. The design of the registry system is fully discussed in chapter IV.

(g) *Availability of multiple security rights in the same assets*

67. Many States do not permit multiple security rights in the same movable assets. Even when non-possessory security rights are recognized, it is often assumed that only one creditor should be entitled to have a security right in a movable asset. This means that a

grantor is effectively required to dedicate the full value of an asset to a single secured creditor, even when the asset has a much higher value than the credit it secures. In order to enable a grantor to use the full value of its assets to obtain secured credit, the regime should be designed to permit multiple grants of security rights in the same asset. The various recommendations in chapters II to IV of the *Guide* are based on the assumption that States will establish regimes that permit grantors to do so.

(h) *Temporal basis for priority among multiple security rights*

68. In order to gain the optimal benefit of permitting multiple security rights in the same asset, the law must provide clear rules for ordering the priority of competing security rights. The *Guide* takes the position that priority should normally be determined by the order of registration of a notice in the registry or of achieving third-party effectiveness by some other means. Chapter V discusses the basic rules for determining priority among competing security rights.

(i) *Priority between security rights and other rights*

69. States that permit non-possessory security rights in movable assets do not always protect these rights (even when they have been made effective against third parties) from being subordinated to subsequent rights. For example, some States permit later-in-time unregistered privileges (such as tax claims) to outrank security rights. In addition, some States do not allow the secured creditor to claim its rights against any good faith purchaser. An effective secured transactions regime requires States to enact precise rules to govern every possible type of priority conflict with the rights of a competing claimant and to avoid, as far as possible, creating any later-in-time rights that would outrank existing security rights. The *Guide* characterizes all these potential conflicts with rights of claimants other than secured creditors as involving priority competitions. Chapter V discusses the full range of detailed priority rules needed to address the rights of competing claimants, including rules that govern conflicts between security rights, on the one hand, and the rights of buyers of encumbered assets or the insolvency representative in a grantor's insolvency, on the other hand.

(j) *Facilitative rather than formalistic regulation*

70. As secured transactions regimes are designed to give creditors property rights in the assets of their grantors, security agreements necessarily produce significant third-party consequences. Many States seek to control the impact of security rights by restrictively enumerating the types of transaction to which parties may agree (*numerus clausus*) and by regulating in detail not only the conditions for creating such agreements, but also the specific terms that may be included in a security agreement. The *Guide* takes the position that, in general, parties should be permitted to design their own security agreements and that any mandatory rules should aim only at ensuring fairness and protecting the legitimate interests of third parties. Chapters VI and VII discuss the rules that should govern the relationship between the parties and the effects of a security agreement on third parties prior to default and enforcement.

(k) *Extrajudicial enforcement*

71. Historically, secured creditors were required to enforce their security rights by applying to a court or other authority and by seizing and selling encumbered assets under a judicial process. Extrajudicial enforcement was permitted only in certain cases and under certain very restrictive conditions. By contrast, the *Guide* recommends that, as long as the enforcement regime is designed to protect the legitimate rights of grantors and third parties, there should be no limitation on a secured creditor's right to enforce out of court. The remedies open to secured creditors upon default by their debtors and the procedures that must be followed to ensure balance and fairness in the enforcement of a security right are discussed in chapter VIII.

(l) *Equality of treatment of all creditors that provide credit to enable grantors to acquire tangible assets*

72. Many States draw a sharp distinction between the rights of sellers and the rights of lenders. In some States, some special rights are given to sellers, usually by permitting them to retain title to the asset sold until the purchase price is paid in full. In other States, lenders are also encouraged to provide credit to purchasers, thereby enhancing competition and lowering the cost of acquisition credit. The *Guide* takes the position that the secured transactions regime should treat sellers and lenders that provide credit to enable a buyer to acquire tangible assets in the same way. The different means by which States can ensure equality of treatment for all providers of acquisition financing are reviewed in chapter IX.

E. Implementing a new secured transactions law

1. General

73. Achieving an effective and efficient secured transactions regime requires States to consider carefully not only policies and principles that have traditionally underpinned this branch of law, but also the relationship between secured transactions law and the general law of obligations, property law, civil procedure law and insolvency law. Many of the key objectives of a modern secured transactions regime can only be achieved if these traditional policies are revisited. This is the case not only for States that are intending to enact their first general secured transactions law, but also for States that have recently enacted specific modifications to their laws to accommodate new commercial practices and needs. Indeed, even States that have already enacted state-of-the-art regimes should subject their existing laws to close scrutiny. The *Guide* takes the position that there is no State that could not benefit from careful examination of existing rules and concepts reflected in its secured transactions regime in the light of the policies, principles and recommendations that the *Guide* sets out.

74. As previously noted, the primary objective of modernizing secured transactions law is to promote the availability of secured credit. However, this goal also points to and reinforces other policies that States may wish to promote. Secured credit serves larger purposes, such as: (a) to facilitate the successful operation and expansion of domestic

businesses; (b) to improve their ability to compete both locally and internationally; and (c) to enable consumers and other purchasers to acquire assets and services upon the most favourable terms. In order to achieve these larger purposes, the regime must meet the actual needs of grantors and secured creditors. Moreover, because adoption of a secured transactions regime reflects a State policy of encouraging economic activity, the regime must also take account of legitimate expressions of State social and economic policy in other sectors. The precise manner in which the benefits of an efficient and effective secured transactions regime should be balanced against other policy goals involves choices about which States may reasonably differ. For example, some States may decide that unpaid employee deductions for pension contributions and unemployment insurance schemes should be accorded priority over security rights. Other States may not provide such priority because they believe that doing so will have a detrimental effect on the availability and cost of credit. The competing considerations that should inform how individual States achieve their own optimal balance of policy goals are discussed throughout the *Guide*.

75. The key objectives and fundamental policies just described should be the foundation for the specific rules of a modern secured transactions regime. Mere enactment of a new law is, however, only a first step. For States to derive the full benefit from establishing an effective and efficient secured transactions regime, the regime must actually take root in the manner intended: it must be used in practice and it must be properly understood and interpreted by business people, financiers, lawyers, arbitrators and judges. Consequently, in designing and drafting legislation to enact a secured transactions regime of the type recommended in the *Guide*, States must attend to a number of issues relating to implementation. These issues are discussed in sections 2 to 4 below.

2. *Harmonization with existing law*

76. In order to be effective in practice, any new secured transactions law must be harmonized with the general legal structure and with the actual role of credit institutions in the enacting State. Sometimes, this implies complementary changes to general legal and economic institutions; sometimes it requires State-specific adjustments to the details of the secured transactions regime itself. In the sense the term is used in the *Guide*, harmonization has three different dimensions.

77. First, because reform of secured transactions law will often not occur in the context of a general reform of a State's private law, the terminology by which the concepts and the rules of the new law are described must be built upon existing legal institutions. Therefore, for example, while the *Guide* provides a detailed elaboration of the meaning of concepts that should be part of a reformed secured transactions law, it takes no position on precise terminology or words to be used in enacting a new law. It is presumed that States will implement the *Guide's* recommendations by reference to existing legal architecture rather than by transplanting unfamiliar legal terms drawn from other jurisdictions that have no legal meaning or resonance. In particular, the *Guide* attempts to present its recommendations and their associated key concepts in such a manner that, whatever the legal tradition that underpins a State's national law, that State can adapt and enact these recommendations.

78. Second, there is no one model governing either the manner of drafting new legislation or the place where these new rules will be located within the overall legal regime of

a State. Therefore, for example, the *Guide* takes no position on whether all the recommendations it makes should be enacted in a single law or whether the recommendations should be incorporated into a civil code or in a commercial code or whether in either case they should appear in the same place. States may well decide to enact rules relating to conflict of laws in a law or a book of a civil code devoted to that subject. Likewise, the *Guide* takes no position on whether States should reform the law through an enactment written in the style of a civil code or in the style of a regulatory instrument. What matters is that lawyers and other legal advisers will be able to provide reliable advice to their clients about what the law requires and that they, as well as judges and arbitrators, will understand, interpret and apply the law in a consistent and coherent way.

79. Third, many of the provisions of a secured transactions law intersect with rules of debtor-creditor law, banking law and practice, as well as insolvency and civil procedure law. The *Guide* acknowledges the need to achieve coherence of the overall regime at each of these points of intersection. For example, while it recommends in chapter VIII on the enforcement of a security right that States provide for expeditious judicial proceedings to decide any questions relating to the rights of grantors, secured creditors or third parties during judicial or extrajudicial enforcement, it does not aim at describing either what those proceedings should be or what rules of civil procedure should apply to them.

3. *Issues of legislative method and drafting technique*

80. Ensuring that the new regime is harmonized with the existing concepts of substantive law is only one dimension of successful implementation. It is also important to pay attention to issues of legislative style. Although presented as recommendations and not as provisions of a model law, the recommendations in the *Guide* are often drafted with a high degree of detail and specificity. This does not mean, however, that States must enact a new law that is framed in such a manner. If drafting techniques in a State presume that legislative provisions are presented first by means of a statement of principle and thereafter by means of exceptions expressed in descending order of generality, this is the style it should follow in its new law. The *Guide* offers extensive commentaries developing the policy rationales for its recommendations so as to enable States to enact legislation that achieves their desired goals without having to adopt any particular drafting style.

81. A second issue of drafting arises because States take different positions as to the relationship between specific laws and general private law. To the extent that recommendations of the *Guide* may constitute exceptions to the general law of property or obligations in a State, it will be necessary for States to determine how to express these exceptions. For example, the *Guide's* recommendations relating to a security right being traceable into proceeds constitutes a major transformation of rules relating to real subrogation in some States and a significant exception to rules denying a right to trace movable assets (see chapter II on the creation of a security right, paras. 79-85). However, the *Guide* takes no position on whether these exceptions should be enacted within the secured transactions regime or be expressed as more general principles modifying the existing rules of property and contracts in other law, such as a civil code. In other words, States should determine the optimal location of these substantive modifications to the general law according to particular judgements they make about legislative style and organization at the time of enactment.

82. Third, because the *Guide* has been prepared for use by States with widely differing legal regimes, it has sometimes been necessary to coin new words to express its key concepts. For example, the *Guide* does not use either of the expressions “purchase-money security interest” (found in some common law jurisdictions) or “vendor’s privilege” (found in some civil law jurisdictions) in its discussion of security rights taken by providers of credit used by grantors to acquire tangible assets. Rather, it uses the generic term “acquisition security right”. In so doing, the *Guide* is not implicitly recommending that States adopt this vocabulary. If an existing expression (such as “purchase-money security interest” or “vendor’s privilege”) resonates with lawyers, sellers and purchasers in a State, the *Guide* presumes that this term could be used in the new law, as long as the substantive rights to which the term thereafter refers are those of the *Guide* and not those of prior law.

83. Fourth, as a general rule and except with regard to the principle of functionalism, the *Guide* avoids the use of “deeming provisions” or legal fictions and adopts the premise that its recommendations can be enacted by States without recourse to deeming provisions or legal fictions. This technique is nonetheless widely used in many States. Thus, the *Guide* leaves the choice of legislative method on this matter to individual States. It does not take a position on whether, for example, States should deem the security right of a lender that provides acquisition financing to be a vendor’s hypothec even though a lender is obviously not a seller, or whether States should give both rights some other label. Instead, the concern addressed in the *Guide* is substantive: however the right is denominated, it should achieve the same functional results for all providers of acquisition financing.

4. *Issues relating to post-enactment acculturation*

84. In its penultimate chapter, the *Guide* sets out a series of recommendations relating to transition (see chapter XI). The concept of transition refers to the question of what rules should apply to determine when any particular security right should be governed by the prior law and when it should be governed by the new law. Establishing workable transition rules that provide precise guidance to business people, financiers, lawyers, judges and arbitrators is essential in order to avoid legal chaos whenever a new law is brought into force. That is, transitional rules are intended to ensure that parties benefit from the new law without, however, disrupting acquired rights, thus making the new law more acceptable.

85. General acceptance of a new secured transactions law does not depend uniquely on good transition provisions. It also requires that individuals and entrepreneurs, their lawyers and other legal advisers see the law as an efficient and effective means for structuring their credit transactions. Ultimately, acceptance requires that all those who are called upon to put the new law into action (such as legal practitioners, judges, arbitrators, academics, bailiffs and registrars) will properly interpret and apply it. Producing the acculturation necessary for quick acceptance of any new law does not occur by happenstance. In implementing a new secured transactions law, States must directly attend to the following four issues.

86. First, it is important that the enactment be accompanied by a relatively thorough legislative commentary that explains the origins and purposes of the new law. This effort might, for example, involve incorporating relevant portions of the commentaries

in the *Guide* into the official commentaries of enacting States. Ideally, these official commentaries could be supplemented by doctrinal writing that provides other examples and illustrations of how the law should work in practice.

87. Second, since the law may well require significant adjustment to existing practices, it may be helpful to provide model forms and precedents, not only for official notices or other documents that must be filed, but also for security agreements themselves. Within a short period of time, lawyers will develop their own contractual precedents, but a series of annotated models can be helpful in illustrating potential transactions under the new law.

88. Third, since most lawyers who will initially be advising clients about the new law will have been educated under the former law, it will be important for associations of lawyers, judges and other professionals and academic institutions and organizations providing law reform assistance to sponsor seminars and colloquiums explaining various features of the new law and how to adapt existing practices and precedents. Without a concerted effort at education, many of the benefits of the new law will not be quickly achieved and mistakes in interpretation are likely to occur.

89. Fourth, it can be anticipated that, almost immediately after enactment, litigation will arise. In States where the results of judicial decisions are not readily accessible (whether through public or private publication), facilities for disseminating judicial decisions and commentary on these decisions should be put in place. A reliable system of case law reporting that will enable lawyers, judges and arbitrators to develop consistent interpretation of the new law will go a long way towards increasing legal certainty and will thereby reduce the volume of future litigation.

F. Recommendation 1

1. In order to provide a broad policy framework for an effective and efficient secured transactions law (the “secured transactions law” is hereinafter referred to as “the law” or “this law”), the law should be designed:

- (a) To promote low-cost credit by enhancing the availability of secured credit;
- (b) To allow debtors to use the full value inherent in their assets to support credit;
- (c) To enable parties to obtain security rights in a simple and efficient manner;
- (d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions;
- (e) To validate non-possessory security rights in all types of asset;
- (f) To enhance certainty and transparency by providing for registration of a notice of a security right in a general security rights registry;
- (g) To establish clear and predictable priority rules;
- (h) To facilitate efficient enforcement of a secured creditor’s rights;
- (i) To allow parties maximum flexibility to negotiate the terms of their security agreement;
- (j) To balance the interests of all persons affected by a secured transaction; and
- (k) To harmonize secured transactions laws, including conflict-of-laws rules relating to secured transactions.

I. Scope of application, basic approaches to secured transactions and general themes common to all chapters of the *Guide*

A. General remarks

1. Introduction

1. States that enact secured transactions laws confront two preliminary and fundamental policy choices. First, they must determine the scope they wish to give to the law to be enacted. This policy choice is addressed in section A.2 of this chapter, which contains a detailed discussion of the scope of the *Guide* (the types of asset that are covered by the *Guide*, the persons that may be parties to transactions covered by the *Guide*, the obligations that security rights are meant to secure, the different kinds of transactions that the *Guide* covers, exclusions from the *Guide* and the implications of these exclusions). Second, States must determine the basic approaches they will take to secured transactions. Section A.3 offers a detailed discussion of the basic approaches to secured transactions that have been developed in the past and that may be found in various States today, prior to outlining the general approach to secured transactions taken in the *Guide*. Section A.4 reviews two key themes that underpin the approach of the *Guide* and that are common to all chapters (the principle of party autonomy and the desirability of using modern electronic technology to the maximum extent possible). The chapter concludes, in section B, with a series of recommendations about the scope of the *Guide*, its basic approach, the principle of party autonomy and the use of modern electronic technology.

2. Scope of application

2. There is no universally accepted definition of secured transactions law. In some States, secured transactions law embraces security rights in both movable assets and immovable property; in other States, the notion is restricted to security rights in movable assets. In addition, in some States, secured transactions law embraces both security rights created by agreement and security rights created by law or judicial process; in other States, the notion is restricted to security rights created by agreement. Moreover, in some States, secured transactions law embraces rights meant to secure the performance of any type of obligation; in other States, the notion is restricted to rights securing the performance only of monetary obligations. Furthermore, in some States, the law of secured transactions embraces all devices that serve the function of securing the performance of an obligation; in other States, the notion is restricted to devices that enable creditors to assert a property right in the assets actually owned by their debtor and thus does not encompass, for example, retention-of-title devices, in which the debtor does not own the assets. The choices that States make about the scope of secured transactions law have a significant impact on the efficiency and effectiveness of the overall regime of secured credit.

3. The fundamental purpose of the *Guide* is to assist States in the development of modern secured transactions laws with a view to promoting the availability of secured credit (see recommendation 1, subparagraph (a)). For the reasons presented in the Introduction, the *Guide* takes the position that the broader the scope of a State's secured transactions regime, the more efficient and effective it will be. Only where overriding concerns exist should certain types of transaction be excluded (see paras. 32-44 below). In other words, in order fully to achieve the benefits of enhanced availability of secured credit, a secured transactions law should be as comprehensive as possible. Consequently, the *Guide* envisions a single, comprehensive regime for secured transactions, encompassing the widest possible array of assets, parties, obligations and transactions (see the purpose statement preceding recommendation 2).

(a) *Assets, parties, obligations, transactions and proceeds*

4. As already noted (see para. 1 above), there are five parameters that will define the scope of a secured transactions regime: (a) the types of asset that are meant to be covered by the regime; (b) the parties (whether creditors or debtors) the regime is intended to cover; (c) the types of obligation that may be secured by a security right governed by the regime; (d) the types of legal transaction that will be regulated by the legal rules established by the regime; and (e) the extension of a security right in an asset to any proceeds arising from the asset. These five parameters are considered below in turn.

(i) *Assets*

5. Traditionally, in many States, security rights are seen as an exception to the general principle of equality among creditors. As a result, the types of asset that may be encumbered with a security right are enumerated restrictively. Modern secured transactions regimes usually take the opposite position: all types of asset should be capable of being the object of a security right, except those specifically excluded. The primary focus of the *Guide* is on core commercial assets, such as inventory and equipment, and trade receivables. However, the types of asset that a grantor may offer as security for credit include many items that are not core commercial assets, such as contractual non-monetary claims, negotiable instruments and rights to payment of funds credited to a bank account. In order to ensure that grantors may utilize all of their assets, whatever their nature, to obtain credit, the *Guide* recommends that a secured transactions regime apply to security rights in all types of movable asset, tangible or intangible, and in present or future assets (see recommendation 2, subparagraph (a)), with the exception of assets specifically excluded (see recommendations 4-7).

6. It is important to specify exactly what this approach entails. First, it means that the *Guide* covers all types of movable asset. It embraces tangible assets such as inventory, equipment and other goods. It also embraces any rights less than full ownership that a debtor may have in such assets, such as a usufruct or contractual rights that a debtor may have in relation to an asset (for example, a right as lessee or licensee). The *Guide* also covers other intangible assets such as contractual and non-contractual receivables, contractual non-monetary claims, rights arising under a negotiable instrument or a negotiable document, rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking and intellectual property rights.

7. The *Guide* also takes a broad approach with respect to receivables.¹ It is meant to cover both: (a) contractual and non-contractual receivables, except that recommendation 23 (on the effectiveness of a bulk assignment of receivables and an assignment of a future receivable or a part of or an undivided interest in a receivable) and recommendation 114 (on representations of the assignor) do not apply to non-contractual receivables; and (b) contractual non-monetary obligations. However, the rights of obligors of contractual non-monetary obligations are subject to law other than the law recommended in the *Guide*.

8. The *Guide* also takes a broad approach to the types of asset that may be encumbered by a security right. It stresses the need to enable a grantor to create security rights not only in its existing assets but also in its future assets (that is, assets that come into existence or are acquired by the grantor after the security agreement is entered into), without requiring the grantor or secured creditor to sign any additional documents or to take any additional action at the time such assets are acquired or created. This approach is consistent, for example, with the United Nations Assignment Convention, which provides for the creation of security rights in future receivables without requiring any additional steps to be taken. In addition, the *Guide* recommends that the secured transactions regime permit the creation of a security right in a changing pool of: (a) existing and future assets of the same kind; and (b) assets of different kinds.

9. The objective of casting the scope of the secured transactions regime as widely as possible is twofold. First, it permits debtors to use all of their assets, as well as the full value of those assets as security for credit, thereby potentially increasing the amount of credit available to them and reducing the cost of that credit. Second, including all types of asset under the regime and permitting grantors to describe the encumbered assets in generic terms enables parties to avoid costly investigation at the time security right is created or costly litigation thereafter about whether any particular type of asset is, or is not, covered by the regime (see chapter II on the creation of a security right, paras. 49-70).

(ii) *Parties*

10. In a manner similar to the restrictive enumeration of assets that could be the object of a security right, historically many States have limited the classes of persons that were entitled either to grant a security right or to become a secured creditor. This was often done by enacting a general prohibition on the grant of a non-possessory security right and then specifically providing that: (a) certain types of grantor (for example, farmers or shopkeepers or manufacturers) were nonetheless permitted to grant a particular kind of non-possessory security right; or (b) certain types of creditor (for example, banks or savings and loan companies or agricultural credit cooperatives) were permitted to take such a security right. Modern secured transactions regimes do not impose restrictions of this nature. They typically provide that the benefits of a secured transactions regime should, in principle, be available to any person, whether physical or legal. This means that there are generally no restrictions on who may be a grantor or secured creditor. This is the position taken by the *Guide* (see recommendation 2, subparagraph (b)).

¹Unlike the United Nations Assignment Convention that applies only to contractual receivables, the *Guide* applies to non-contractual receivables as well (see Introduction, section B, terminology and interpretation “receivable” and footnote 30).

11. Unless specifically indicated otherwise, the *Guide* also applies to consumers and consumer transactions. There is no reason why consumers should be deprived of the benefits of the regime envisaged in the *Guide*. However, the *Guide* acknowledges that States often enact comprehensive consumer protection laws. Thus, to the extent that a rule of the regime envisaged in the *Guide* conflicts with consumer protection law, the *Guide* defers to consumer protection law. States that do not have a body of law for the protection of consumers may wish to consider whether the enactment of a law based on the recommendations of the *Guide* would affect the rights of consumers and would thus require the introduction of consumer protection legislation (see recommendation 2, subparagraph (b)). In addition, while the matter is less likely to arise as a practical matter, to the extent that the banking law of a State may limit a bank's rights to take certain types of security right in certain types of asset, the *Guide* also defers to that law.

(iii) *Obligations*

12. The secured transactions law of many States often limits the types of obligation that can be secured by a security right. For example, in many States only present and determinate obligations may be secured. However, because of the vast array of types of obligation that are routinely assumed by enterprises, most modern secured transaction regimes take an expansive view of the obligations capable of being secured by a security right. The *Guide* adopts this approach. It recommends that a broad range of obligations, monetary and non-monetary, may be secured (see recommendation 2, subparagraph (c)). Monetary obligations could include, for example, demand loans, term loans, lines of credit and obligations to pay the balance of the purchase price. Non-monetary obligations may include obligations to perform a particular task (for example, to build a particular machine) or obligations to refrain from doing something (for example, non-competition clauses). Present obligations or future obligations may be secured, as long as they are determinate or determinable.

(iv) *Transactions*

13. The final component that determines the scope of a secured transactions regime is the range of transactions that are embraced. As noted, in some States it is not possible to create a non-possessory security right. In these States, the grantor must give up possession of the asset to be encumbered to the creditor or someone acting on the creditor's behalf. Further, in some States only transactions that are explicitly denominated as secured transactions and that permit a creditor to claim a security right in the assets actually owned by its grantor fall within the secured transactions regime. In order to ensure a comprehensive coverage of all devices that serve security functions, modern secured transactions regimes have neither of these limitations and the *Guide* also adopts this approach. First, the *Guide* recommends that both possessory and non-possessory security rights in movable assets be permitted and covered. Second, the *Guide* recommends that the regime govern a broad range of transactions that serve security functions (see recommendation 2, subparagraph (d)).

14. This second point is especially important in view of the large number of property rights that, while not denominated as security rights, nevertheless serve security

purposes. These property rights include, for example, transfers of title in tangible assets for security purposes, transfers of receivables for security purposes and the various forms of retention of title (see recommendation 2, subparagraph (d)). The rationale for including all these different devices within the *Guide*, regardless of how they are currently denominated in national law, is explained in detail in the next section of this chapter (see also recommendation 8).

15. As the basic purpose of the *Guide* is to promote access to secured credit, its recommendations deal primarily with security rights created by agreement. It does not directly address issues relating to encumbrances that arise by statute or judicial process. Nonetheless, because these encumbrances sometimes are given priority over security rights, the *Guide* cannot ignore them. For this reason, the *Guide* also contains recommendations that speak to the interaction of security rights with these encumbrances (see recommendations 83-86).

(v) *Proceeds*

16. The above review of the basic components of a secured transactions regime illustrates a fundamental evolution in the manner in which security rights are conceived. Historically, States took the position that a security right is the consequence of a specific agreement to create a right in a specific asset that belongs to a specific grantor, in favour of a specific creditor, securing a specific obligation (and that none of these elements of the transaction would change during the life of the security agreement). In modern secured transactions regimes, this degree of specificity does not exist. Frequently, the creditor may change as loans are assigned in full or in part from one lender to another, the obligation may change as a present obligation is paid off and a new obligation arises and the encumbered asset may change (for example, as inventory is sold and replaced, and as receivables are paid and new receivables are generated).

17. There is, in addition, a further feature of modern secured transactions regimes that constitutes a major component of the scope of these regimes. These regimes typically permit the security right to extend to any proceeds that arise from an encumbered asset. This principle of carrying the security right forward into proceeds is generally thought necessary to protect the rights of the secured creditor whenever a grantor sells or leases an encumbered asset. However, there are many forms of proceeds in addition to those that arise from the sale or lease of encumbered assets.

18. To appreciate fully the scope of the idea of proceeds, it is necessary to consider all the different ways in which tangible assets may be subject to legal and physical transformation over time. For example, if a tangible asset is an animal, various modifications to it are possible. Female animals give birth to offspring and some may produce products such as milk or wool. Still other prize animals may produce marketable semen or ova. Bees produce honey and silk worms produce silk. In all these situations, original encumbered assets may generate other assets for the grantor even without a disposition of the encumbered assets. In many legal systems this type of asset is referred to as “natural fruits”.

19. Tangible assets may also produce intangible assets. For example, they may be leased and generate rental payments from the lessee. In addition, intangible assets may

produce other intangible assets (for example, rents may generate interest). Both rents and interest are often known as “civil fruits” or “revenues”. Moreover, a tangible asset may be of a type that can be manufactured or otherwise transformed into an asset of another type. Wood may become a chair and steel may become part of an automobile. Here, the original encumbered asset is not disposed of, but the process of manufacture turns it into another, more valuable, asset. Assets that result from this transformation are often called “products of manufacture”.

20. In other words, in the terminology of property law, these diverse new movable assets are variously characterized as being natural and civil fruits or revenues and the products of manufacture. For the purposes of secured transactions law, however, the specific label is often not important. What matters is the policy decision that States make concerning the effect of the security right in the natural and civil fruits or revenues and products of manufacture. That is, in each of these cases, States must decide whether a security right that is taken in the animal, steel, right to payment or leased asset may extend to any of the assets “produced” by that original encumbered asset.

21. A further feature of movable assets is the fact that often they are made in order to be sold, leased or licensed (sometimes more than once). When original encumbered assets are sold, leased or licensed during the time in which the obligation they secure is outstanding, the grantor typically receives, in exchange for those assets, cash, tangible assets (for example, equipment or negotiable instruments) or intangible assets (for example, receivables). This being the case, States must determine whether a security right that is taken in the original encumbered assets should extend to new assets that are received in exchange for those original encumbered assets when they are sold, leased or licensed. Therefore, for example, States must decide whether a security right in a piece of equipment such as a printing press extends to the money that is received by the grantor when it sells the printing press or to another printing press that is received in exchange for the press that has been sold. In the terminology of property law, such cash or other tangible or intangible assets received in exchange upon a sale or other transfer is considered to be “proceeds of disposition”. Once again, for the purposes of secured transactions law, it is often much less important whether the asset received upon disposition of an original encumbered is another asset, cash, a receivable or a negotiable instrument. What matters is whether the security right in the original encumbered asset may be claimed in (that is, may “extend to”) this new asset.

22. In some cases, the initial proceeds of the original encumbered assets (whether in the form of natural and civil fruits or revenues, products of manufacture or proceeds of disposition) may themselves generate other proceeds when the grantor disposes of the initial proceeds in return for other assets. Such proceeds are sometimes referred to as “proceeds of proceeds”. If there is a security right in proceeds of original encumbered assets, it should, logically, extend to proceeds of proceeds, as long as they remain identifiable as proceeds. That is, if the secured creditor were to lose its right in proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case if there were no security right in proceeds.

23. In some legal systems, natural and civil fruits or revenues are clearly distinguished from proceeds arising from disposition of original encumbered assets and are made subject to different rules. The difficulty in identifying proceeds of disposition and the need to protect rights of third parties in proceeds are often cited to justify this approach. That is,

in these systems, fruits are held to be automatically covered by a security right in the original encumbered asset that produced the fruits. By contrast, proceeds of disposition are seen to be replacement property that is not covered by the security right in the original encumbered asset. Other legal systems do not make a sharp distinction between fruits and proceeds of disposition of encumbered assets. Both are made subject to the same rules. The difficulty in distinguishing between natural and civil fruits or revenues and proceeds of disposition, as well as the fact that both fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets, are among the reasons typically given to justify this approach.

24. Today, most States that have modernized their secured transactions regimes consider all the various transformations noted in this section to constitute proceeds of the original encumbered asset. Given this legislative tendency and because the extension of the security right to such assets reflects the standard expectations of parties to a security agreement, the *Guide* takes the position that all the above-mentioned transformations constitute proceeds arising from the original encumbered asset. Consequently, under the *Guide*, a security right extends to proceeds of an encumbered asset in any of these forms (see recommendation 2).

(b) *Outright transfers of receivables*

(i) *Inclusion of outright transfers of receivables*

25. As an almost universal principle, the *Guide* does not apply to devices that do not serve security functions. The only exception to this principle arises in relation to outright transfers of receivables (that is, transfers that are not intended to secure an obligation). This exception is found in most modern secured transactions regimes. It is justified by the fact that the practical mechanics at the point of collection of a receivable that has been the subject of an outright transfer and the enforcement of a security right in a receivable are identical. The exception is also justified because it is often difficult to determine at the outset of a transaction whether an assignment is by way of security or is an outright transfer. The *Guide* therefore recommends that all assignments of receivables (the *Guide* uses the term “assignment” only with respect to receivables), whether by way of security or not, should be subject to the same rules relating to creation, third-party effectiveness, priority and, to a limited extent, enforcement (see para. 30 below and recommendations 3 and 167).

26. In determining the scope of recommendation 3, however, it is important to note that the meaning of the term “receivable”, as used in the *Guide*, excludes a right to payment under a negotiable instrument, a right to receive the proceeds under an independent undertaking and a right to payment of funds credited to a bank account (see Introduction, section B, terminology and interpretation). As a result, the *Guide* does not apply to outright transfers of such assets. It does, nonetheless, apply to transfers of these types of asset if the transfer is made for security purposes.

27. The reason for excluding outright transfers of negotiable instruments, rights to receive the proceeds under an independent undertaking and rights to payment of funds credited to a bank account is that these transactions raise different issues and would require

special rules. For example, in the case of ordinary receivables, rights under a security transfer and rights under an outright transfer would, under the *Guide*, compete for priority based on the order of registration of a notice of the security right or outright transfer. However, the rules governing priority would be different for negotiable instruments, rights to receive the proceeds under an independent undertaking and rights to payment of funds credited to a bank account. In the case of a negotiable instrument, a secured creditor can always obtain a superior right by taking possession of the instrument (see recommendation 101). Similarly, with respect to rights to receive the proceeds under an independent undertaking and rights to payment of funds credited to a bank account, a secured creditor can always obtain a superior right by control (see recommendations 103 and 107).

28. Principles of secured transactions law could easily be made applicable to the outright transfer of a promissory note and perhaps to a bill of exchange other than a cheque in a manner similar to the *Guide's* coverage of the outright transfer of receivables. However, those principles would not apply well to the outright transfer of cheques. In addition, the latter topic is sufficiently covered by the law of negotiable instruments and the law of bank collections.

29. An enacting State that wishes to expand the scope of its secured transactions law to apply to outright transfers of negotiable instruments that are either promissory notes or bills of exchange (and to expand its definition of security right to cover the right of the transferee in such a transaction) might wish to consider providing that an outright transfer of such a negotiable instrument is automatically effective against third parties upon the transfer. Such a rule would avoid disrupting existing financial practices. With respect to the priority of such a right, the general principles of priority set forth in the *Guide* would apply. Most particularly, the general principle in recommendations 101 and 102 would govern. As in the case of an outright transfer of a receivable, the outright transferee of such a negotiable instrument should be able to enforce the instrument without further consent of the assignor, subject to the rights of the obligors on the negotiable instrument as described in chapter VIII on the enforcement of a security right.

(ii) *Effect of inclusion*

30. The recommendation that the law should apply to outright transfers of receivables despite the fact that such transfers do not secure the payment or other performance of an obligation primarily envisions issues of creation, third-party effectiveness and priority. As for the collection or other enforcement of an outright transfer of a receivable, the recommendations of the *Guide* generally do not apply, except to clarify that the assignee has the right to collect the receivable and that collection must proceed in a commercially reasonable manner (see recommendation 167).

31. It is important to note that the *Guide's* coverage of outright transfers of receivables in no way obliterates the distinction between an outright transfer of a receivable and a transfer of a receivable as security for an obligation. Nonetheless, the *Guide* makes irrelevant any distinctions in form or terminology among transactions that secure payment or other performance of an obligation. That is, while the recommendations of the *Guide* cover outright transfers and a common terminology is used (see, for example, the term “security right”, which includes outright transfers of receivables, “secured creditor”,

which includes outright transferees of receivables and “grantor”, which includes outright transferors of receivables), the *Guide* does not transform outright transfers into security rights. Such a result (sometimes referred to as “re-characterization”) would be undesirable and indeed harmful for important practices such as the securitization of receivables.

(c) *Aircraft, railway rolling stock, space objects and ships*

32. The *Guide* does not cover assets such as aircraft, railway rolling stock, space objects, ships and other categories of mobile equipment, in so far as these assets are covered by national laws or international agreements to which the State enacting legislation based on the *Guide* is a party and in which the matters covered by this law are addressed (see recommendation 4, subparagraph (a)). As a result, for example, where there exist registries and detailed rules on security and other rights in ships, aircraft and the other types of mobile equipment described in recommendation 4, subparagraph (a), the *Guide* does not apply. It follows that, where such national laws or international agreements to which a State is a party do not apply to these categories of assets, the *Guide* will apply. The reference to aircraft, railway rolling stock, space objects and ships should be understood according to the meaning of those terms in national law or international conventions dealing with them.

(d) *Intellectual property*

33. In view of the increasing importance and economic value of intellectual property to businesses seeking to obtain secured credit, the *Guide* applies in principle to security rights in intellectual property. However, as the recommendations have not been prepared with intellectual property issues in mind, in the case of any inconsistencies with national law or international agreements, to which a State is a party, relating to intellectual property the *Guide* would not apply (see recommendation 4, subparagraph (b)).

34. In this regard, a State should examine its existing laws relating to intellectual property and the State’s obligations under treaties, conventions and other international agreements relating to intellectual property and, in the event that the recommendations of the *Guide* are inconsistent with any such existing laws or those treaties, conventions or international agreements, the State’s secured transactions law should expressly confirm that those existing laws and treaties, conventions or international agreements govern such issues to the extent of the inconsistency.

35. In addition, a State enacting secured transactions legislation in accordance with the *Guide* should consider whether it might be appropriate to adjust certain of its secured transactions law rules as they apply to security rights in intellectual property in so far as they are inconsistent with national law or international agreements to which a State is a party relating to intellectual property. Such secured transactions law rules include, but are not limited to, those reflected in the following recommendations of the *Guide*: recommendations 38 and 77-78 on the third-party effectiveness and priority of a security right subject to a specialized registration system; recommendation 81, subparagraph (c), on the priority of the rights of a non-exclusive licensee in the licensor’s ordinary course of

business; and recommendation 208 and 218, subparagraph (b) on the law applicable to security rights in intangible assets.

36. In considering whether any adjustments of secured transactions law rules as they apply to security rights in intellectual property are appropriate, a State should analyse each circumstance on an issue-by-issue basis and should have proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with international conventions and national laws. Matters that should also be taken into account include whether intellectual property law addresses the taking of security in intellectual property and whether it provides for the registration of notices about security rights in intellectual property. All these details will be addressed in a forthcoming supplement to the *Guide*.

(e) *Securities*

37. The *Guide* does not apply to security rights in securities because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. In addition, the substantive law issues relating to security rights and other rights in securities held with an intermediary are not addressed in the *Guide*, because they are dealt with in the Unidroit Convention on Substantive Rules for Intermediated Securities (Geneva, 2009).² The law applicable to rights in securities is not addressed in the *Guide*, since it is dealt with in the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, prepared by the Hague Conference on Private International Law.³

38. The *Guide* is structured in such a way that the State enacting legislation based on the regime recommended in the *Guide* can, at the same time, implement the texts prepared by Unidroit and the Hague Conference on Private International Law, as well as relevant texts prepared by UNCITRAL, such as the United Nations Assignment Convention⁴ and the UNCITRAL Insolvency Guide.⁵

(f) *Financial contracts and foreign exchange transactions*

39. The *Guide* also does not apply to security rights in two other categories of movable asset: (a) payment rights arising under or from financial contracts governed by netting agreements, except a receivable owed on the termination of all outstanding transactions; and (b) payment rights arising under or from foreign exchange transactions. The *Guide* takes this position because financial contracts and foreign exchange transactions raise complex issues that require special rules.

(g) *Immovable property*

40. In some legal systems, the regime of secured transactions extends to both movable assets and immovable property. Nonetheless, encumbrances on immovable property are,

²See Introduction, footnote 12.

³See Introduction, footnote 11.

⁴See Introduction, footnote 7.

⁵See Introduction, footnote 2.

in principle, excluded from the scope of the *Guide* because they raise different issues (see recommendation 5). For example, encumbrances on (and title to) immovable property are typically subject to a special document registration system and indexed by asset, not by grantor. However, immovable property may nevertheless be affected by the *Guide*'s recommendations.

41. In most legal systems, attachments to immovable property (that is, tangible assets that are physically attached to immovable property without losing their separate identity) are themselves treated as immovable property. In other legal systems, as long as tangible assets attached to immovable property retain their separate identity, they are not considered to be immovable property. Regardless of whether the attachment is itself characterized as immovable property, the *Guide* is applicable to security rights in such an attachment and, consequently, if such an attachment is characterized as immovable property, in this respect the *Guide* affects immovable property (see recommendations 21 and 43).

42. In addition, the *Guide* addresses encumbrances on immovable property in certain cases where a security right in immovable property (for example, a mortgage) secures a receivable, negotiable instrument or other intangible asset. Should the receivable, negotiable instrument or other intangible asset be assigned, the *Guide* recommends that the assignee receive the benefit of the encumbrance on the immovable property. The justification is a general rule found in most legal systems that the accessory (the encumbrance on the immovable property) follows the principal (the assigned obligation). However, to avoid undermining the rights of third parties under immovable property law, the application of the *Guide* does not affect any third-party rights, or priority and enforcement requirements relating to encumbrances on immovable property under immovable property law (see recommendations 25, subparagraph (c), and 48).

(h) Proceeds of excluded types of asset

43. Certain types of asset excluded from the scope of the *Guide* can nevertheless give rise to proceeds in the form of assets that would, on their face, be covered by the *Guide* (for example, receivables representing proceeds of immovable property). In principle, the *Guide* applies to security rights in such assets. Nevertheless, it may be that law other than secured transactions law (for example, immovable property law) also confers a security right in types of proceeds to which the secured transactions law applies. There could be significant confusion should both regimes apply to the proceeds in such cases. For this reason, if other law provides that a security right in such proceeds does exist, the *Guide* takes the position that secured transactions law applies to that security right only to the extent that other law does not apply to that security right (see recommendation 6).

(i) Other exceptions

44. The objectives of the *Guide* are best achieved by a comprehensive secured transactions regime with as broad a scope as possible. The objective is both to include in the scope of the secured transactions regime a wide range of transactions and to provide that that regime contains as few exceptions as possible (see, for example, recommendation 83). For this reason, the *Guide* recommends that there should be no limitations to

its scope of application other than those specifically set out in the *Guide* (see recommendation 7, first sentence). If, nonetheless, other limitations are introduced (for example, the exclusion of employment benefits), those limitations should be set out in the law in a clear and specific way so as to avoid undermining certainty as to the scope of the law (see recommendation 7, second sentence).

3. *Basic approaches to secured transactions*

(a) *Introduction*

45. Over time, a broad variety of practices have been developed by States to encourage lenders, sellers and other financiers to extend credit to borrowers, buyers and other debtors. States have often granted special statutory rights to lenders and sellers for this purpose. Commonly, States have also established regimes to enable creditors and debtors to contract between themselves for special rights and prerogatives. In both cases, the objective was to give the creditor a preference over other creditors in the distribution of the proceeds generated by the seizure and sale of a debtor's property in the event the debtor failed to perform the promised obligation. These various types of rights can, broadly speaking, be understood as security rights.

46. The *Guide* draws on the different approaches found in various legal traditions, suggesting modifications to existing law and practice where appropriate, to develop recommendations for a modern secured transactions regime that is best designed to promote secured credit.

47. This section has several purposes. An initial goal is to provide a survey of the major approaches to affording security to creditors. In addition, the section discusses the advantages and disadvantages of each approach, both to the immediate parties involved (that is, the secured creditor and the grantor) and to third parties. The section then outlines the major policy options for legislators in selecting among the various possible approaches. Throughout, the section stresses the reasons why modernization of the law in this area is essential in order to promote secured credit and the contexts in which the need for modernization is most pressing.

48. In general terms, the devices that currently are being used for purposes of security fall into three broad categories. First, there are specific devices designed to be, and openly denominated as, security devices (see section C.2 below). Second, there are title (ownership) devices that, in combination with various types of contractual arrangement, are used to secure the performance of an obligation by the debtor (see section C.3 below). Third, there are integrated, comprehensive security devices embracing every form of security device and title (ownership) device under a functionally defined generic concept of a security right (see section C.4 below).

49. As noted, in many States today, not all legal devices that are meant to encourage lenders, sellers and other parties to extend credit are based on an agreement. Some devices arise by operation of law. The more important of these devices will be noted in each section below. However, since statutory encumbrances are, for the most part, outside the scope of the *Guide*, the following discussion will focus on security devices based on an agreement.

(b) *Traditional secured transactions*

(i) *Security rights in tangible assets*

50. Most States distinguish between security rights in tangible assets and security rights in intangible assets. Because tangible assets may, by their nature, be the subject of physical possession and because many States attach significant legal consequences to such possession, States often permit creditors to obtain security in tangible assets by means that are not available for intangible assets. That is, in the case of security rights in tangible assets, most States draw a distinction between possessory and non-possessory security rights. In the case of possessory security rights, possession of the encumbered asset is transferred to the secured creditor or a third party acting on behalf of the secured creditor. In the case of non-possessory security rights, the grantor (which is usually the debtor but can also be a third party) retains possession of the encumbered asset.

a. *Pledge*

51. By far the most common type of security right in tangible assets is the pledge. Traditionally, a pledge requires for its validity that the grantor relinquish possession of the encumbered asset. Today, by contrast, many States have extended the term “pledge” to situations where the grantor retains physical possession of the encumbered asset. In the *Guide*, these modern types of pledge are considered to be non-possessory security rights, not pledges.

52. An ordinary pledge arises in the following situations. Most commonly, the grantor gives up possession of the encumbered asset to the secured creditor or to a third party that acts on behalf of the secured creditor. A pledge also arises where a grantor allows the secured creditor (or an agreed-upon third party) that may already be in possession of the encumbered asset for some reason to retain possession of the encumbered asset thereafter as a pledge. The third party in such cases is frequently an agent or trustee that holds the security in the name or for the account of the creditor or a syndicate of creditors. The dispossession of the grantor must not only occur when the security right is created, but must also be maintained for the entire duration of the pledge. The return of the encumbered asset to the grantor usually extinguishes the pledge.

53. In many States, dispossession of the grantor need not always require physical removal of the encumbered assets from the grantor’s premises, provided that the grantor’s access to the assets is precluded in another way. This result can be achieved, for example, by giving to the secured creditor the keys to the warehouse in which the encumbered assets (such as merchandise or raw materials) are stored, provided that doing so prevents any unauthorized access by the grantor. The same result can be achieved by transferring effective possession of the encumbered assets to a third party. For example, an independent warehousing company may be engaged to exercise control over the encumbered assets on the grantor’s premises, as agent for the secured creditor. Under such an arrangement (sometimes known as field warehousing), the encumbered assets are stored in an area of the grantor’s premises that is fenced-off, delineated or in some other way placed under the exclusive control of the warehousing company. For these types of arrangement to be valid, several conditions must usually be satisfied. It must be obvious to a third party that the

grantor does not have free access to the encumbered assets. In addition, there cannot be any unauthorized access by the grantor to the area in which the pledged assets are stored. Furthermore, the employees of the warehousing company cannot work for the grantor. If they are drawn from the grantor's workforce because of their expertise or for other reasons, the terms of their employment must be adjusted so that they work for the warehouse company and no longer work for the grantor.

54. While most pledges are taken over tangible assets (for example, equipment and inventory), they also may be taken over other types of tangible asset. For example, it is possible to pledge various documents and instruments (whether negotiable or non-negotiable) that embody rights in tangible assets (for example, bills of lading or warehouse receipts that embody rights in goods) or in intangible assets (for example, negotiable instruments that embody rights in receivables). In these cases, the grantor is dispossessed of the pledged asset through the transfer of physical possession of the document or instrument to the secured creditor.

55. As a security right, the pledge presents several important advantages for the secured creditor, including the following. First, the grantor is unable to dispose of the pledged assets without the secured creditor's consent. Second, the secured creditor does not run the risk that the actual value of the pledged assets will be reduced through the grantor's failure to provide necessary upkeep or maintenance. Third, the pledge can accommodate situations where the secured creditor wishes to use the pledged assets. In such situations, the consent of the grantor is required and the secured creditor must take proper care of the assets. Fourth, if enforcement of the pledge becomes necessary, the secured creditor is saved the trouble, time, expense and risk of having to seek to obtain delivery of the encumbered assets from the grantor. Fifth, if the pledged asset is an instrument that bears interest payable to the holder, the pledge facilitates the creditor's collection of the interest as instalments become due.

56. The pledge also has advantages for third parties, especially when these third parties are the grantor's other creditors. The required dispossession of the grantor avoids any risk of creating a false impression of the grantor's wealth (that is, that the grantor owns the pledged assets free of any security rights) that might result if the assets were in the grantor's possession. The dispossession of the grantor also minimizes the risk of fraud (that is, that the grantor will misrepresent that it owns the assets free of any security rights).

57. At the same time, the pledge also has major disadvantages, both for the grantor and the secured creditor. For the grantor, the greatest disadvantage is the required dispossession itself, which precludes the grantor from using the encumbered assets in its business. This disadvantage is acute in situations where possession is necessary for commercial grantors to generate the income from which to repay the loan (as is the case, for example, with raw materials, semi-finished or finished products and equipment). This disadvantage alone makes the pledge economically impractical in many business contexts. Another important disadvantage is that the grantor cannot pledge assets that do not yet exist or in which the grantor does not have rights at the time of the pledge. This means that a number of important financing practices, such as inventory financing pursuant to a revolving credit facility, cannot be accommodated by a traditional pledge.

58. For the secured creditor, the pledge has the disadvantage that the secured creditor has to store, preserve and maintain the encumbered assets, unless these tasks are delegated to a third party. Where secured creditors are themselves either unable or unwilling to perform these tasks, entrusting them to third parties usually will involve additional costs that will be directly or indirectly borne by the grantor. Another disadvantage is that a secured creditor in possession of certain types of encumbered asset (such as a warehouse receipt or a bill of lading) may be exposed to liability in various circumstances for loss or damage caused by the encumbered assets. Such liability may exceed the amount of the credit extended, as is typically the case where the encumbered asset causes contamination of the environment (see chapter II on the creation of a security right, para. 71).

59. However, where these disadvantages do not pose a problem (either because they are not relevant or because the parties have been able to address them), the pledge can be utilized successfully and efficiently as a security device. There are two major fields of application. The first field of application is where the encumbered assets are already held by, or can easily be brought into the possession of, a third party, especially a person engaged in the business of maintaining possession of assets owned by other persons (such as a warehouse). The second field of application is negotiable instruments and negotiable documents, which can easily be held by the secured creditor or its agent.

b. Right of retention of possession

60. A right of retention of possession of an asset may be created either by statute or by agreement to secure payment of an obligation. As statutory rights of retention of an asset are generally outside the scope of the *Guide*, they are noted only briefly here. Many States have extensive regimes governing statutory retention rights. Typically, these regimes cover carriers, warehouses, repairers and improvers of assets. In some States, lawyers, accountants, architects and other professionals are also given a right of retention over documents belonging to their clients. All of these types of right of retention arise from the general legal principle of contract law that a party is not required to perform its obligation until the other party is ready, willing and able to perform the correlative obligation. Most of these types of statutory retention right do not give the retainer any special enforcement rights, and some do not even permit the retainer that seizes and sells the retained assets to claim a priority in the proceeds of the sale in the context of enforcement.

61. In addition to these limited statutory rights of retention, many States permit contracting parties to extend the scope of the general legal principle of retention. In such States, parties may agree that, if one of them breaches a contractual obligation, the other may withhold its own performance even when the performance relates to a different contract between the parties. Most often, these agreements deal with the right of one party to withhold an asset that, under the terms of some other contract, it would be obliged to deliver to the party in breach. For example, a bank need not return a bill of lading or a promissory note that it holds for its customer or allow withdrawals from the customer's bank account if the customer is in default in repayment of a credit and had granted the bank a right of retention with respect to the bill of lading, promissory note or bank account. Where a right of retention is reinforced by a valid power to sell the retained item, some legal systems regard such a reinforced right of retention as a type of pledge, even though the method of its creation deviates from that of the ordinary pledge. Alternatively, a reinforced right of

retention may be regarded simply as having some of the effects of a pledge without actually being a pledge. The most important consequence of drawing this analogy with a pledge is that the creditor in possession has a priority in the assets retained. Most commonly, the priority of the retaining creditor is absolute but, in some States, an earlier-created and effective non-possessory security right may be given priority in limited cases.

c. Non-possessory security rights

62. As already noted (see para. 57 above), a pledge of tangible assets required for production or sale (such as raw materials, semi-finished or finished products and equipment) is usually economically impractical.

63. To address this problem, individual States have attempted to find appropriate solutions according to specific local needs and in conformity with the general framework of their legal system. Especially in the second half of the twentieth century, those States began to recognize security rights in movable assets outside the narrow confines of the traditional pledge. In some cases, this recognition was reflected in the enactment of new laws. However, in many cases it resulted from practice and court decisions.

64. The result is a diverse range of solutions. An indication of the existing diversity is the wide variety of names for the relevant devices. The more common names and techniques are: fictive dispossession of the grantor, non-possessory pledge, registered pledge, *nantissement*, warrant, movable hypothec, contractual privilege, bill of sale, chattel mortgage, floating charge and trust receipt. That is, while some States sought to create a denominated non-possessory security device over movable assets, other States simply modified the rules governing existing devices, such as the pledge, in order to permit non-possessory security rights to be used.

65. An even more relevant feature of these legislative reforms is that most were conceived as limited responses to specific problems and were therefore given a restricted scope of application. For example, in some States there is one type of non-possessory security device applicable to business and commercial equipment, another applicable to the financing of raw materials and a third only applicable to retail inventory. Only a few States have enacted a general statute creating a single non-possessory security right applicable to all types of tangible asset. Furthermore, some States have different sets of legislation on non-possessory security rights depending on the type of business enterprise in question: one may deal with security for financing of industrial and artisanal enterprises, another with security for financing of farming, forestry and fishing enterprises, another with security for financing of mining, oil and gas industries and a fourth with transactions between individuals. Finally, in many States there is a variety of statutes on non-possessory security rights, each covering only a small economic sector, such as the acquisition of cars or farm machinery or the production of motion pictures.

66. Some States have addressed the matter through a non-possessory security device known as a fixed charge or a floating charge. Under this type of device, a security right (the charge) is denominated as “fixed” or “floating” depending upon the degree of control that the secured creditor exerts with respect to the encumbered asset. In general, the secured creditor has a fixed charge on an encumbered asset if the grantor is not permitted

to sell or otherwise dispose of the asset without the creditor's consent (which is generally the case with equipment that the grantor uses in its business). Conversely, the secured creditor has a floating charge on an encumbered asset if the grantor is permitted to sell or otherwise dispose of the asset without the consent of the secured creditor (which is generally the case with inventory that the grantor is free to sell in the ordinary course of its business). The relevance of the difference between a fixed charge and a floating charge on an asset relates to the priority of the charge: a fixed charge generally represents a paramount charge on the asset, while a floating charge may be subject to certain preferential claims in favour of tax authorities and other third parties or a carve-out in favour of unsecured creditors (see also chapter II on the creation of a security right, paras. 61-70).

67. In some States, there is a reluctance to recognize non-possessory security rights in inventory. This is sometimes based upon a perceived inconsistency between the secured creditor's right to sell the inventory upon default and the grantor's right to sell the same inventory in the ordinary course of its business. Another reason is a perceived conceptual problem with granting a security right in assets that are identified as a pool of assets. A third reason may arise from a policy decision to reserve a grantor's inventory for the satisfaction of the claims of the grantor's unsecured creditors.

68. Varied as the legislation providing for non-possessory security rights may be, it often shares one common feature, namely, that some form of publicity of the security right is required or available.

69. One purpose of publicity, such as that provided by the possession of a pledged asset, is to dispel the false impression of wealth that might arise if the security right in assets in the possession of the grantor is not apparent to third parties. It is often argued, however, that, in a modern credit economy, parties should assume that assets may be encumbered by a lender's security right or may be subject to a seller's retention of title. For this reason, the argument goes, a general requirement that non-possessory security rights be published is not necessary to protect third parties. Such general assumptions, however, are bound to increase the cost of credit. To begin with, even in cases where the person in possession is the owner and the assets are not encumbered, a creditor will be concerned about the risk that there is a hidden encumbrance and will increase the cost of credit accordingly. Alternatively, that risk might be reduced (although not avoided entirely) in some cases through an extensive, time-consuming and costly search. Finally, in some cases it might not even be possible to conduct a meaningful search and so the cost of credit will reflect the creditor's increased risk.

70. In some States, a second purpose of publicity, which underlies the creation of a public registry for security rights, is the desire to provide a simple mechanism for enabling secured creditors to prove, as an evidentiary matter, the existence of their security rights and the time when they are created. In these cases, the registry may serve this function in lieu of a professional notary. By contrast with registries that are aimed primarily at providing information to third parties, evidentiary registries focus on the secured creditor and are often not searchable by third parties that may be prospective credit providers.

71. In States that do require creditors with non-possessory security rights to publicize their rights, the registry systems put in place often fail to protect sufficiently the secured creditor or other third parties. Many of these States have separate registries for each type

of security right and, even when two different types of security right can encumber the same asset, these registries are typically not cross-indexed. Moreover, the registries often do not reveal the name of the owner, previous secured creditors or the amount secured, or provide information as to the asset encumbered. Finally, in systems based on the general assumption that assets will be encumbered, which, consequently, do not have integrated and fully transparent registries, there is no objective basis for a creditor to know the actual extent to which assets are encumbered and the relative priority of competing security rights. The result is that grantors may not be able to use the full value of their assets to obtain credit.

72. There appears to be a widely recognized need to bridge the gap between the general economic demand for non-possessory security rights and the often-limited access to such security under current law in many States. A major purpose of legal reform in the area of secured transactions is to improve the law in the field of non-possessory security rights and in the related field of security in intangible assets (see section C. 2(b) below).

73. While modern regimes demonstrate that this gap can be effectively bridged, experience shows that legislation on non-possessory security rights requires more effort than simply “modernizing” the traditional possessory pledge regime. This is due mainly to the following four key characteristics of non-possessory security rights. First, as the grantor retains possession of the encumbered assets, it has the power to dispose of them or to create a competing right in them, even against the secured creditor’s will. This situation necessitates the introduction of rules concerning the effects and priority of such dispositions (see chapter V on the priority of a security right). Second, the secured creditor must ensure that the grantor in possession takes proper care of the encumbered assets, duly insures them and protects them to preserve their commercial value. These matters must be addressed in the security agreement between the secured creditor and the grantor (see chapter VI on the rights and obligations of the parties to a security agreement). Third, if enforcement of the security right becomes necessary, the secured creditor will usually prefer or need to obtain possession of the encumbered assets. However, if the grantor is not willing to part with possession of those assets, judicial proceedings may have to be instituted. Proper remedies, and possibly accelerated enforcement proceedings, may have to be provided (see chapter VIII on the enforcement of a security right). Fourth, the appearance of false wealth in the grantor, which is created by “secret” security rights of third persons in assets held by the grantor, may have to be counteracted by various forms of publicity (see chapter IV on the registry system).

74. In light of the generally recognized economic need for non-possessory security rights and the basic differences between possessory and non-possessory security rights discussed above, new legislation will be necessary in many States. Taking account of the relative advantages and disadvantages of the legislative models discussed above, legislators may be faced with three options. One option is to adopt integrated legislation for both possessory and non-possessory security rights (see section C.4 below). This is the approach, for example, taken by the OAS Model Inter-American Law on Secured Transactions. A second option is to adopt integrated legislation for non-possessory security rights, leaving the regime on possessory security rights to other domestic law. A third approach is to maintain a fragmented system of different security rights for different types of grantor, different types of asset and different types of security (possessory and non-possessory), but to ensure that all issues relating to third-party effectiveness, priority and enforcement are dealt with under the same set of rules.

75. The prevailing trend in modern legislation, at both the national and international levels, is towards an integrated approach, at least as far as non-possessory security rights are concerned. The contrary approach, one that involves a selective regulation of specific types of non-possessory security right, is likely to result in gaps, overlaps, inconsistencies and lack of transparency, as well as in discontent in those sectors of industry that might be excluded. In addition, such selective regulation makes it more difficult to address conflicts of priority between possessory and non-possessory security rights in States that choose to retain separate regimes for these two types of security right.

d. Non-possessory statutory rights

76. In many States that do not have general regimes governing contractual non-possessory security rights, credit is encouraged through statutes directly creating particular non-possessory encumbrances in favour of certain categories of creditors. Among the more common beneficiaries of these statutory encumbrances are sellers, suppliers of materials, artisans, tradesmen and repairers. These regimes typically do not provide the designated creditor with any special enforcement remedies. The beneficiary of the encumbrance must obtain a judgement against the debtor and then seize the property of the debtor in the ordinary way. The sole advantage that the creditor obtains is a priority for payment (or privilege) that may be claimed in the proceeds of the sale through which enforcement is effected. Moreover, because the beneficiary of such an encumbrance is not obliged or permitted to publicize its encumbrance, it is rare that the encumbrance can be claimed in an asset that no longer belongs to the debtor.

77. The existence of statutory non-possessory encumbrances does go some way in encouraging the designated beneficiaries to advance credit to their debtors. However, these encumbrances have several disadvantages. They are not available to all types of credit provider. They are secret, in the sense that there is no easy way for other third parties to know of their existence. They do not give creditors access to expeditious and effective enforcement remedies that are likely to generate a higher price upon the sale of the asset. Finally, they provide only a fragile protection to creditors since they normally cannot be claimed once the debtor no longer owns the asset. For all these reasons, the modern trend is for States to cut back on the number of non-possessory statutory encumbrances and to expand both the categories of creditors that may contract for a non-possessory security right and the types of asset over which a non-possessory security right may be obtained by agreement.

(ii) Security rights in intangible assets

78. Intangible assets comprise a broad variety of rights, such as receivables and intellectual property. In view of the dramatic increase in the economic importance of intangible assets in recent years, there is a growing demand to use these rights as security for credit. Intangible assets in the form of intellectual property often represent a significant component of the value of other assets, as in the case of inventory and equipment (for example, products bearing a valuable trademark and equipment incorporating software essential to its operation). Furthermore, proceeds of inventory or equipment may take the form of intangible property. Other forms of intangible assets include securities and many kinds of payment rights arising under complex financial contracts (these types of asset are excluded from the *Guide*; see paras. 37-39 above).

79. By definition, intangible assets are incapable of being physically possessed. Nevertheless, laws in many States have dealt with the creation of security rights in intangible assets, at least in the case of receivables, by modifying the regime governing the creation of possessory pledges. Some laws have attempted to create the semblance of dispossession by requiring the grantor to transfer to the creditor any writing or document relating to the pledged receivable. However, such a transfer, in itself, is usually not sufficient to create the pledge. Rather, the grantor must be dispossessed of the asset. In many States, this dispossession is symbolized by requiring that a notice of the pledge be given to the debtor of the receivable.

80. In some States, techniques have been developed that achieve ends comparable to those attained by the possession of tangible assets. The most radical method is the full transfer of the encumbered right, or at least the encumbered share of it, to the secured creditor. However, this goes beyond creation of a security right and amounts to a transfer of title, whether conditionally or absolutely (see section C. 3(a) below). In some other States, title to the encumbered assets is not affected, but dispositions of encumbered assets by the grantor that are not authorized by the secured creditor are blocked by agreement. In the case of a right to payment of funds credited to a bank account, for example, if the grantor (that is, the holder of the account) agrees that its account can be blocked in favour of the secured creditor, the secured creditor has the equivalent of possession of a tangible asset. This is especially the case if the depositary bank itself is the secured creditor.

81. Such techniques of obtaining notional possession of intangible assets are sometimes referred to as “control” in modern secured transactions regimes. In general, a secured creditor is deemed to have control of an asset if it has the contractual right to direct the disposition of the asset. For example, in some States a secured creditor may be deemed to have control of a right to payment of funds credited to a bank account if the depositary bank has contractually bound itself, in a document often referred to as a “control agreement”, to dispose of the funds in the account exclusively at the direction of the secured creditor. The degree of control may vary. In some cases, the control is absolute and any disposition by the grantor is prevented. In other cases, the grantor is allowed to make certain dispositions or dispositions up to a fixed maximum aggregate amount or until the occurrence of a specified triggering event.

82. States that have enacted comprehensive regimes for non-possessory security rights in tangible assets and established general security rights registries (see section C. 2 (a) above) typically extend the registry system to cover assignments of receivables. This approach serves to provide consistency, since the sale of inventory results, as a rule, in receivables being generated and it is often desirable to extend the security in inventory to the resulting proceeds. Moreover, in some States, opening the registry to assignments of receivables has the additional benefit of relieving the secured creditor (assignee) of the obligation to notify the debtor of the receivable as a precondition to creating a security right. This is so because, in certain secured transactions involving a pool of present and future receivables that are not specifically identified, individual notification of the debtors of the receivables may not be practical or feasible. In addition, even in situations where such notification is practical or feasible, it may not be desirable because the grantor (assignor) may wish to keep the assignment confidential.

83. The above discussion leads to the conclusion that, when designing a regime to govern security rights in intangible assets, States will face a basic choice. They may attempt to regulate security rights in intangible assets in a regime separate from that governing security rights in tangible assets, in which case the technique for generating security will closely resemble a transfer of title. Alternatively, States may attempt to create an integrated regime that seeks to create a common set of principles governing creation, third-party effectiveness, priority and enforcement of security rights in tangible and intangible assets alike.

84. The predominant tendency in modern legislation is to develop regimes that treat security rights in intangible assets under an integrated regime that also governs security rights in tangible assets. This approach permits grantors and secured creditors to determine at the outset of their transaction the assets to be encumbered and to establish the relationship between rights in receivables as proceeds and rights in receivables as the original encumbered assets.

(iii) Use of title for security purposes

85. In many States, alongside various devices and techniques that are intended to function as security rights (see section C.2 above), there exists a variety of other legal instruments that can be deployed to generate the equivalent of a security right. The majority of these instruments were developed through commercial practices (the validity of which was subsequently confirmed by courts), but some were either established or refined by legislation. The most common instruments and techniques for creating the equivalent of a non-possessory security right in tangible and intangible assets involve the use of title to (or ownership of) the asset that is being deployed for security purposes. There are two situations in which title is routinely used for security purposes. First, title may be used to guarantee a loan: the grantor conditionally transfers title in an asset that the grantor already owns to the creditor (see section C. 3(a) below). Second, title may be used to secure an unpaid purchase price: a seller or lessor simply retains title to the asset that is sold or leased until full payment of the purchase price has been made (see section C. 3(b) below). Both transfer of title and retention of title enable the creditor to benefit from rights that are equivalent to non-possessory security rights.

a. Transfer of title

86. Traditionally, transactions involving the transfer of title from a borrower to a lender are the mechanism used to secure the performance of the borrower's repayment obligation. As States develop the idea of security rights (in particular in relation to land), the deployment of title as security begins to fall into disuse. There is a different pattern, however, where movable assets are concerned. Because many legal systems were hostile to non-possessory security rights in such cases, debtors and creditors looked elsewhere in the law to fashion techniques that could be used to overcome this hostility. The transfer of title of the assets to the secured creditor (either conditionally until the loan is repaid or subject to a re-transfer to the borrower under a second sale by which the creditor retains title until the loan is repaid) was the most usual technique deployed for this purpose.

87. Today, there are two features that continue to make transfer of title as a security device attractive for creditors in many States. First, in those States, the formal and substantive requirements for transferring title in a tangible asset or intangible property to another person are often less onerous, and therefore less costly, than the requirements for creating a security right. Second, in the case of enforcement, and in the case of the grantor's insolvency, a creditor often enjoys a better position as an owner than as a holder of a security right. This is especially the case where an owner's assets, although in the grantor's possession, are determined not to be part of the insolvency estate. By contrast, where the grantor's assets are merely encumbered by a security right, they are generally considered to be part of the grantor's insolvency estate (see chapter XII on the impact of insolvency on a security right, para. 20).

88. These two features are not, however, invariably present in national law. For example, in many States the formal difference between using title for security purposes and a security right with respect to the requirements for creation and enforcement has been eliminated and title devices and security rights are treated identically. Thus, some States even require creditors seeking to enforce a title right that has been transferred to them for security purposes to follow the enforcement regime that applies to regular security rights. Furthermore, many of these States provide that, while security transfers are generally subject to the rules applicable to transfers of title, in the case of insolvency, they are treated as security devices.

89. The security transfer of title has been established by law in some States (usually under techniques denominated as a "sale with a right of redemption" or a "sale with an option to repurchase") and by practice confirmed by courts in other States. Today, States approach transfer-of-title devices that are intended to serve security purposes in a variety of ways. As noted, in some States, their creation is subject to the less demanding rules governing transfers of title and they have the effect of a full transfer of title. In other States, their creation is subject to the more cumbersome rules governing security rights and they have only the effect of a secured transaction. In yet other States, especially in the civil law world, many if not all such transfers of title are regarded as a circumvention of the ordinary regime of security instruments and are, therefore, held to be null and void. In States that have adopted a comprehensive and integrated regime for non-possessory security rights, transfer-of-title devices for security purposes are available but are simply treated as security devices. In these States, the creation, third-party effectiveness, priority and enforcement of a transfer of title for security purposes are subject to the same requirements applicable to security rights (see section C.4 below).

90. Legislators are faced with two policy options. One option is to recognize security transfers of title with the (usually) reduced requirements and the greater effects of an outright transfer of title, thus avoiding the general regime for security rights. This option results in enhancing the secured creditor's position (although at the risk of increasing its liability (see chapter II on the creation of a security right, para. 71), while weakening the position of the grantor and the grantor's other creditors.

91. The other option is to recognize security transfers of title, but to align the requirements or the effects or both with those of a security right. This can be achieved in one of two ways. On the one hand, States could specify the transfer-of-title transactions that will be permitted, prohibiting all others, and subject the permitted devices to the creation, third-party effectiveness, priority and enforcement regime applicable to security rights. Some

civil law States have taken this first approach. On the other hand, States could simply provide that these security transfer-of-title transactions will be characterized as security rights. Many common law States have taken this second approach. Under both of these alternatives, the transferee's advantages and corresponding disadvantages to other parties are reduced. The second alternative is the approach followed in States with a functional, integrated and comprehensive secured transactions regime and is also the approach recommended in the *Guide* (see recommendation 9).

b. Retention of title

92. The second method of using title as security is effected by techniques that permit sellers to use their title to tangible assets being sold to secure payment of the purchaser's financial obligation to pay the purchase price for the assets. The most common, but not exclusive, means for doing so is through a contractual retention-of-title (reservation-of-ownership) arrangement. Nonetheless, there are several other mechanisms by which sellers may deploy title, some arising by statute and others arising by agreement between the parties.

93. In many States, the law of sale permits creditors that have actually transferred title to the buyer to seek the annulment of the sale if the buyer does not pay the purchase price. Upon annulment, the seller may reclaim ownership and possession of the sold asset free and clear of any encumbrances that the buyer may have created in it. These reclamation rights typically arise by operation of law, although in some States sellers are able to extend the reclamation right by contract beyond that provided in the law of sale. As the *Guide* focuses on security rights created by agreement, these statutory seller's remedies will not be discussed further here (for a more complete discussion, see chapter V on the priority of a security right, paras. 107-109, and recommendation 86).

94. In a simple retention-of-title arrangement, the seller may retain title to the sold asset until full payment of its purchase price. Lenders may also participate in such financing by accepting an assignment of the secured obligation from the seller. There are several varieties of retention-of-title transactions. Sometimes, the seller merely promises to sell the asset to the buyer and the sale (and transfer of title) is completed only upon full payment. Other times, the sale is made conditional upon the purchaser paying the full price. Most often, however, the sale is immediate and it is only the transfer of title that is made conditional upon the buyer paying the price. The common thread in all these varieties is that, even though the buyer may have possession and use of the asset (and in some cases may even have the right to dispose of the asset), it does not actually obtain rights in the asset until the purchase price is fully paid. Until that time, title to the asset remains vested in the seller.

95. States also permit variations in the scope of retention-of-title agreements. Sometimes these variations relate to the obligation that has been secured and sometimes they relate to the asset that is subject to the retention of title. For example, in an "all-monies" or "current-account" retention-of-title arrangement, the seller retains title to the assets that have been sold until all obligations owed by the buyer have been discharged, whether such obligations relate to those specific assets or to other assets purchased by that buyer from the seller. In what is known as an "extended" retention-of-title arrangement, the

seller's rights may also extend to receivables or other proceeds arising upon the sale of the assets. However, such an arrangement exists in very few States. In any case, even in States where extended retention-of-title arrangements are permitted, the right to the proceeds generally is extinguished when the proceeds are commingled with other proceeds. In the vast majority of States, retention of title does not extend to proceeds. In addition, in almost all States, retention of title extends to assets only while they retain their identity. Thus, the right is extinguished once those assets are incorporated into other assets in the manufacturing process or otherwise lose their original identity.

96. An alternative to a retention-of-title arrangement, but with the same economic result, can be achieved by combining a lease contract with an option in favour of the lessee to purchase the leased asset at a nominal price. In these arrangements, the option to purchase can normally be exercised only after the lessee has paid most of the notional purchase price through rent instalments (see the example given in the Introduction, para. 26). In some cases, where the lease covers the full useful life of the leased equipment, it is equivalent to a retention-of-title arrangement even without an option to buy. These variations are all intended to function as devices to enable a borrower to finance the acquisition of either equipment or inventory (see chapter IX on acquisition financing). For ease of reference, in the following paragraphs, at least with respect to leases that serve a security function, the term "sale" includes the term "lease", the term "seller" includes the term "lessor" and the term "buyer" includes the term "lessee".

97. Economically, a retention-of-title arrangement provides a security right that is particularly well adapted to the needs of sellers in securing credit. In many States, this kind of credit, which is typically made available by suppliers, is widely used as an alternative to general bank financing and is given preferential status in view of the importance for the economy of small- and medium-sized suppliers of tangible assets. In other States, banks also provide acquisition financing on a more regular basis and, as a result, have developed practices that enable them to take advantage of the retention-of-title mechanism. For example, a seller can sell tangible assets to a bank for cash and the bank then can resell the assets to the buyer on credit under a retention-of-title arrangement; or a buyer might pay the seller in cash from a loan and then transfer title to the bank as security for the loan. In those States, this source of credit and its attendant specific security is often accorded a special privilege in the form of a higher priority over conflicting security rights in the same tangible assets, provided that certain formal requirements are complied with.

98. Due to the origin of a retention-of-title arrangement as a term of a contract of sale or lease, many States (including a number of States that treat security transfer-of-title devices as the equivalent of security devices) still regard the retention-of-title arrangement as a mere quasi-security right. As a result, these States do not subject retention-of-title devices to the general rules applicable to security rights, notably as to creation, third-party effectiveness, priority and enforcement. A further advantage is that retention of title can be agreed upon in a cost-effective way since, in many States, it is not subject to publicity.

99. At the same time, retention-of-title arrangements present certain disadvantages. The position of the buyer and the buyer's creditors is weakened and, in the absence of publicity, third parties have to rely on the buyer's representations or take the time and incur the cost to collect information from other sources. Another disadvantage is that retention-of-title arrangements may prevent, or at least impede, the buyer from using the purchased assets

for granting a second-ranking security right to another creditor. Yet another disadvantage is that enforcement by the buyer's unsecured creditors is impossible or difficult without the seller's consent. For these reasons, in some States retention-of-title arrangements are treated in the same way as security rights in every respect. In other States, the same considerations lead to these arrangements being treated as security rights in some but not all respects (for example, they are subject to publicity but are given a special priority status). In yet other States, retention-of-title arrangements are ineffective as against third parties in general or if they relate to certain assets, especially inventory, on the theory that the seller's retention of title is incompatible with the seller granting to the buyer the right and power to dispose of the inventory in the ordinary course of its business.

100. Several policy options may be considered by States. One option is to preserve the special character of retention of title as a title device. Under this approach, retention of title would not be subject to any requirements as to form or publicity. Another, slightly different, option is to preserve the special character of retention of title but to limit its effects to securing only the purchase price of the affected asset to the exclusion of any other credit and to restrict it to the purchased asset to the exclusion of proceeds or products. A third option is to integrate retention-of-title arrangements into the ordinary system of security rights. In such a case, the creation, third-party effectiveness, priority and enforcement of a retention-of-title arrangement, even in the buyer's insolvency, would be subject to the same rules applicable to security rights. Under such an approach, for the policy reasons mentioned above, it would be possible to grant the seller certain advantages (such as priority as of the time of the conclusion of the sales contract in which the retention-of-title clause was contained or as of the time of delivery of the goods). A fourth option is to keep the retention of title as a separate transaction, but to place it fully on a par with any other security right (that is, without granting the retention-of-title seller any special privileges relating to creation, third-party effectiveness, priority or enforcement). All these options are discussed in greater detail in chapter IX on acquisition financing.

(iv) Functional, integrated and comprehensive approach to secured transactions

101. Throughout the twentieth century, the credit demands of business were often frustrated by the lack of a suitable legal framework through which borrowers could grant security rights to lenders and other credit providers. Sometimes, the law explicitly prohibited the granting of security rights over certain types of asset. Sometimes, an appropriate legal device simply did not exist. Sometimes, parties were able to cobble together a legal device to serve their purposes, but it was inefficient, costly and complex to operate. These problems were at the source of many of the developments just reviewed. For example, they led to contractual practices and legislative innovations permitting fictitious pledges and to the creation of specialized legal transactions meant to solve problems created in specific sectors of economic activity. They also stimulated the development of a variety of transfer-of-title mechanisms and were responsible for both the extensive deployment of retention-of-title agreements and the different variations on retention of title intended to increase its efficiency as a legal device for securing the performance of an obligation.

102. Faced with the complexity, inefficiency and gaps created by this ad hoc approach to adjusting legal regimes to meet the credit needs of business, by the middle of the

twentieth century some States decided to rethink the whole field of security rights in movable assets. The creation of a single functional, integrated and comprehensive concept of a security right in all types of movable asset was the result of this reflection. This approach to secured transactions was inspired by the observation that the many different types of non-possessory security right, the traditional possessory pledge and the several variations on title-transfer and retention-of-title devices were all based upon a few identical guiding principles that aimed at achieving the same economic outcomes.

103. The main theme in this new approach to secured transactions is that substance must prevail over form. It is no accident that this idea first developed in federal States, such as the United States of America and Canada, where for many years trade across state and provincial boundaries was hampered by the existence of diverse and highly particularized regimes for granting security. The United States Uniform Commercial Code, a model law now adopted by all 50 states (including the mixed common law and civil law state of Louisiana), created a single, comprehensive security right in movable assets, unifying numerous and diverse possessory and non-possessory rights in tangible and intangible assets, including transfer-of-title and retention-of-title arrangements, that existed under state statutes and common law. The idea spread to Canada (including, with slight modifications, the civil law province of Quebec), New Zealand, India and various other States, many of which are civil law jurisdictions in Central and Eastern Europe. The OAS Inter-American Model Law on Secured Transactions follows a similar approach in many respects. Likewise, the EBRD Model Law on Secured Transactions follows a similar approach in that it creates a specific security right that can work side by side with other security devices (such as leasing) and re-characterizes retention of title as a security right.

104. As an approach to creating an efficient regime that enhances the provision of secured credit to enterprises and consumers, such a functional, integrated and comprehensive security system presents a number of significant advantages.

105. First, all relevant statutes dealing with non-possessory security rights (which are often great in number) may be merged into one text, an approach that ensures comprehensiveness, consistency and transparency of the rules. Second, the rules on possessory security rights, especially the possessory pledge, may be covered and at the same time adapted to contemporary requirements. Third, title devices, such as security transfer and retention of title, may be integrated into the system in a way that not only gives sellers the protection they desire, but also enables buyers to use whatever value they have acquired in assets being purchased to obtain additional credit. Fourth, contractual arrangements that fulfil a security function, such as leasing contracts, sale and resale and sale and leaseback, may also be included and covered in a way that minimizes conflict and confusion about the priority of the rights of the different creditors involved in these transactions. Fifth, this approach promotes competition among credit providers by placing sellers, lessors and lenders on a level playing field.

106. In addition, under this approach a creditor that envisages granting a secured loan need not investigate the different prerequisites of the various alternative security devices and evaluate their respective advantages and disadvantages. Correspondingly, the burden borne by a grantor's creditors or an insolvency representative in a grantor's insolvency that must consider their rights and duties vis-à-vis the secured creditor, is lessened if only one regime, characterized by a comprehensive security right, has to be examined.

Simplifying these burdens will reduce not only the cost of creating security rights but also the cost of enforcement and, concomitantly, will lower the overall cost of secured credit.

107. In cross-border situations, the recognition of security rights created in assets in one State that are then moved to another State will also be facilitated if the State into which the assets are moved recognizes a comprehensive security right. Such a system can much more easily accept a broad variety of foreign security rights, whether these are of a narrow or an equally comprehensive character, a circumstance that is likely to promote cross-border commerce.

108. There are, however, some disadvantages to the functional, integrated and comprehensive approach. First, this approach may require re-characterization of certain transactions (for example, transfer of title or retention of title as a security device), at least for the purpose of secured transactions laws. For States that do not already accept the relativity of title to movable assets, it will be necessary to provide for educational programmes for lawyers and business people to assist them in understanding how such an approach would operate in practice. In addition, this approach requires adjusting the basic legal logic that has heretofore underpinned the law relating to security rights in a large number of States. For example, in many States, security rights are conceived to be exceptions to the general principle of equality of creditors and must therefore be restrictively interpreted. Moreover, a security right is usually conceived of as a specific right, over specific assets, to secure a specific obligation, owed by a specific debtor to a specific creditor. The functional, integrated and comprehensive approach presumes that these traditional limitations will be displaced by a general principle favouring the spread of secured credit. Finally, this functional, integrated and comprehensive approach normally assumes that the new regime will be brought into force in a single piece of legislation. For some States this will involve significant adjustment to the manner in which their civil codes, commercial codes and other statutes are organized.

109. Many of these disadvantages can be reduced or eliminated by careful attention to the manner in which a State chooses to develop legislation creating a functional, integrated and comprehensive regime of security rights. For example, it would be possible to achieve most of the advantages while avoiding most of the disadvantages through: (a) a comprehensive reform of existing laws relating to security rights, title devices serving security purposes, the assignment of receivables and financial leases; and (b) the enactment of specific statutory rules to regulate contractual practices that have been developed to overcome gaps in the law. This is not to minimize the effort required to do so in a manner that would achieve consistency, transparency, efficiency and the establishment of genuine competition among all providers of credit on the basis of price or other terms. However, if the legislative reforms are undertaken in one coordinated endeavour, the benefits would be considerable in relation to the costs and difficulties of doing so.

(v) *Approach of the Guide*

110. For the various reasons given in this section and in section C of the Introduction, the *Guide* recommends that States adopt the functional, integrated and comprehensive approach to secured transactions (see recommendation 8, first sentence). In enacting a functional, integrated and comprehensive regime, either of two different approaches could be used. Under one approach, the names of the old security devices, such as pledge,

floating charge, transfer of title for security purposes and retention of title, would be preserved and used. However, their creation and effects as security rights would be made subject to a functional, integrated and comprehensive set of rules, even though, for other purposes (for example, taxation or accounting) they would continue to be subject to other rules. This approach maintains a conceptual diversity of security devices and other contractual arrangements that may be used for purposes of security, but provides for a common set of rules governing creation, third party-effectiveness, priority and enforcement. Under a slightly different approach, all types of rights serving security purposes would be abolished and the specific transactions and financing practices they envisioned would be subsumed into a single, uniform notion of security rights. There would be a single set of rules applicable to all secured transactions because there would only be one type of security device available. Both these approaches have been taken in States that have recently enacted functional, integrated and comprehensive secured transactions regimes and both achieve the key objectives elaborated in the *Guide*.

111. As a general approach, except in connection with acquisition financing, the *Guide* recommends that States adopt the second of these two approaches to enacting a functional, integrated and comprehensive secured transactions regime (see recommendation 8, second sentence). Under this approach, all secured transactions, no matter how denominated, are classified as security rights and are subjected to an identical regulatory framework. With respect to acquisition financing alone, however, the *Guide* recommends that States have the option of adopting either of the two approaches mentioned in the previous paragraph. That is, States may adopt what is characterized, for the specific case of acquisition financing, either a unitary or a non-unitary approach (see recommendation 9). Under a unitary approach, the same basic principles elaborated under recommendation 8 would apply to all acquisition financing transactions (see recommendation 9, subparagraph (a)). Under a non-unitary approach, States would retain separately denominated acquisition financing devices. All acquisition financing transactions other than retention-of-title sales and financial leases would be classified as acquisition security rights governed by the same set of rules that would govern acquisition financing transactions (see recommendation 9 subparagraph (b) (i)). In addition, the ownership rights of a retention-of-title seller and a financial lessor would be maintained, but the specific rules governing each transaction would be adjusted so as to produce outcomes that are functionally equivalent to those produced by an acquisition security right (see recommendation 9, subparagraph (b) (ii)).

112. In principle, a unitary approach to acquisition financing might be easier to implement, since it would not require adjustments or references to other laws. Likewise, a unitary approach would also provide more transparency, since all the relevant rules would be in one statute. However, the *Guide* recognizes that some States may not be in a position to adopt the unitary approach where acquisition financing transactions are concerned and therefore contemplates that, in this particular situation, States might choose to adopt a non-unitary approach to acquisition financing (for a more detailed discussion, see chapter IX on acquisition financing).

4. Two key themes common to all chapters of the Guide

113. The previous sections of this chapter have highlighted two overarching ideas that promote open competition among providers of credit. First, a regime that is comprehensive

in scope, embracing all types of transaction that are deployed to secure the performance of an obligation, makes it possible for everyone to offer credit terms on a level playing field. In principle, no special advantages are conferred on any particular class of debtor or creditor. Secondly, a regime that takes a functional, integrated and comprehensive approach reduces transaction costs by eliminating the need to design different transactions for different debtors and different assets based only on formal differences and by permitting creditors to achieve third-party effectiveness and establish a priority position in a simple and uniform way.

114. This section discusses two other important themes that should inform a modern secured transactions regime. One of these, the principle of party autonomy, recalls the fact that security rights arise from an agreement between grantors and secured creditors. The other signals the increasing importance of modern technology for ensuring an effective and efficient system of commercial law. While neither theme points to a single specific outcome, both provide general orientations for States seeking to enact a new secured transactions law. Both also support a number of specific recommendations that are found in the various chapters of the *Guide* (such as recommendations 94 and 54, subparagraph (j)). For this reason, they are presented here as two key themes complementing the ideas of comprehensiveness in the scope of law and a functional and integrated approach to regulating security rights.

(a) *Party autonomy*

115. In modern economies, the purposes being pursued by debtors and creditors are extremely diverse. To facilitate achievement of these purposes, secured transactions regimes place great emphasis on the principle of party autonomy. The main idea is to provide parties with maximum flexibility to negotiate security agreements that meet their precise needs. Thus, mandatory rules should be kept to the minimum required to ensure transparency and predictability of rights and fairness in enforcement.

116. As security agreements give creditors property rights in the assets of their debtors, they necessarily also produce significant third-party consequences. For this reason, modern secured transactions regimes also make it clear that any terms of the agreement that derogate from or modify non-mandatory rules only bind the parties themselves and, except to the extent provided by general principles of contract law, do not affect the rights of third parties.

117. While party autonomy gives credit providers significant power and may affect rights of other creditors, the expectation is that permitting the secured creditor and the grantor to structure their transaction in a way best suited to their objectives will normally permit grantors to gain wider access to secured credit. Nonetheless, many States are reluctant to embrace the principle of party autonomy without any limits. They seek to limit party autonomy by restrictively enumerating the types of transaction to which parties can agree and by regulating in detail not only the conditions for creating and enforcing such agreements, but also the specific terms that could be included in a security agreement. By contrast, other States take the position that parties should be permitted to derogate from any rules of the secured transactions regime that do not reflect overriding considerations of public policy.

118. The latter approach is more consistent with the overall objective of an effective and efficient secured transactions regime. It gives the parties the greatest scope for tailoring their transactions to meet their specific credit needs. This is one of the most important ways in which a secured transactions regime can promote secured credit. The *Guide* adopts this approach. It recommends that States adopt the principle of party autonomy as the basic premise of a secured transactions law, subject only to a small number of specific limitations as set out in recommendations under subsequent chapters of the *Guide* (see recommendation 10; see also chapter VI on the rights and obligations of the parties to a security agreement).

(b) Use of modern electronic technology

119. Modern secured transactions regimes not only reflect modern concepts of secured transactions law, but also accommodate modern business practices and take advantage of modern developments in State regulatory practices. The *Guide* takes note of these practices and developments in three areas.

120. First, the *Guide* adopts the position that States should generally facilitate electronic communications. In this spirit, and consistent with article 9, paragraphs 2 and 3, of the United Nations Convention on the Use of Electronic Communications in International Contracts⁶ and articles 6 and 7 of the UNCITRAL Model Law on Electronic Commerce,⁷ the *Guide* contains recommendations recognizing the ability of parties to conduct business using electronic communications. The central idea is that a secured transactions law should not impede modern commerce by preventing parties from meeting any of the requirements relating to a writing or a signature by using appropriate electronic methods (see recommendations 11 and 12 of the *Guide*; see also paras. 143-165 of the explanatory note by the UNCITRAL secretariat on the Electronic Communications Convention,⁸ and the UNCITRAL Model Law on Electronic Commerce with Guide to Enactment, 1996, with additional article 5 bis as adopted in 1998, paras. 47-61).

121. Second, the *Guide* recognizes that the law relating to negotiable documents in electronic form is evolving rapidly. Nonetheless, in view of the particular difficulty of creating an electronic equivalent of paper-based negotiability, the various recommendations of the *Guide* have been prepared only with reference to negotiable instruments and negotiable documents in paper form. However, the *Guide* should not be interpreted as discouraging the use of electronic equivalents of paper negotiable instruments or negotiable documents. Thus, the *Guide* contemplates that an enacting State that wishes to address this matter could do so in a manner that is consistent with the recommendations of the *Guide*, but will need to devise its own special rules for this purpose (the United Nations Convention on the Use of Electronic Communications in International Contracts also does not address the electronic equivalent of paper-based negotiability).⁹

122. Third, as noted in recommendation 1, subparagraphs *(c)*, *(e)* and *(f)*, the *Guide* is premised on adoption of three important concepts relating to third-party effectiveness of

⁶United Nations Publication, Sales No. E.07.V.2.

⁷*Ibid.*, Sales No. E.99.V.4.

⁸*Ibid.*, Sales No. E.07.V.2.

⁹*Ibid.*, Explanatory Note, para. 7.

security rights. It promotes non-possessory security rights in both tangible and intangible assets of a grantor. In addition, it proposes simple formalities for creation of a security right between the parties, along with simple additional steps aimed at transparency for making the security right effective against third parties. Moreover, it recommends establishment of a general security rights registry and registration of a notice relating to existing or potential security rights as the general method for achieving third-party effectiveness (see recommendation 32). While the *Guide* acknowledges that the general security rights registry might be kept in paper form, it recommends that, if possible, States take advantage of modern technology by establishing the registry in electronic form (see recommendation 54, subparagraph (j)). The details of how such a computerized registry may be established and operated are discussed more fully in chapter IV on the registry system.

E. Recommendations 2-12

Purpose

The purpose of provisions on the scope of application of the law is to establish a single comprehensive regime for secured transactions. The provisions specify the security rights and other rights to which the law applies. The purpose of provisions on basic approaches to security is to ensure that the law:

- (a) Applies to all contractually created rights in movable assets that secure the payment or other performance of an obligation (“functional approach”); and
- (b) Provides for the appropriate implementation of the functional approach so as to ensure that all providers of secured credit are treated according to rules that produce functionally equivalent outcomes.

Scope of application

2. Subject to recommendations 3-7,¹⁰ the law should apply to all rights in movable assets created by agreement that secure payment or other performance of an obligation, regardless of the form of the transaction, the type of the movable asset, the status of the grantor or secured creditor or the nature of the secured obligation. Thus, the law should apply to:

- (a) Security rights in all types of movable asset, tangible or intangible, present or future, including inventory, equipment and other tangible assets, contractual and non-contractual receivables, contractual non-monetary claims, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking and intellectual property;
- (b) Security rights created or acquired by all legal and natural persons, including consumers, without, however, affecting rights under consumer-protection legislation;
- (c) Security rights securing all types of obligation, present or future, determined or determinable, including fluctuating obligations and obligations described in a generic way; and
- (d) All property rights created contractually to secure the payment or other performance of an obligation, including transfers of title to tangible assets for security purposes, assignments of receivables for security purposes, the various forms of retention-of-title agreements and financial leases.

¹⁰Where reference in a recommendation is made to a recommendation found in a different chapter, the reference includes the number and subject of the chapter in which that other recommendation is found. Where no such reference is made, the recommendations referred to are in the same chapter as the recommendation that contains the reference.

The law should also apply to security rights in proceeds of encumbered assets.

Outright transfers of receivables

3. The law should apply to outright transfers of receivables despite the fact that such transfers do not secure the payment or other performance of an obligation. This recommendation is subject to the exception provided in recommendation 167 (chapter VIII on the enforcement of a security right).

Limitations on scope

4. Notwithstanding recommendation 2, the law should not apply to:

(a) Aircraft, railway rolling stock, space objects and ships, as well as other categories of mobile equipment in so far as such asset is covered by a national law or an international agreement to which the State enacting legislation based on these recommendations (herein referred to as “the State” or “this State”) is a party and the matters covered by this law are addressed in that national law or international agreement;

(b) Intellectual property in so far as the provisions of the law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property;

(c) Securities;

(d) Payment rights arising under or from financial contracts governed by netting agreements, except a receivable owed on the termination of all outstanding transactions; and

(e) Payment rights arising under or from foreign exchange transactions.

5. The law should not apply to immovable property. However, recommendations 21, 25 (chapter II on the creation of a security right), 43, 48 (chapter III on the effectiveness of a security right against third parties) 87, 88 (chapter V on the priority of a security right) 164, 165 (chapter VIII on the enforcement of a security right) 184, 195 and 196 (chapter IX on acquisition financing) may affect immovable property.

6. The law should provide that if, under other law, a security right in an excluded type of asset (for example, immovable property) extends to a type of proceeds to which this law applies (for example, receivables), this law applies to the security right in the proceeds except to the extent that that other law applies to that security right.

7. The law should not include any other limitations on its scope of application. To the extent any other limitations are introduced, they should be set out in the law in a clear and specific way.

Functional approach

8. The law should adopt a functional approach, under which it covers all rights in movable assets that are created by agreement and secure the payment or other performance of an obligation, regardless of the form of the transaction or the terminology used by the parties (including rights of transferees under a transfer of title to tangible assets for security purposes, rights of an assignee under an assignment of receivables for security purposes, as well as rights of sellers or financial lessors under various forms of retention-of-title agreement and financial leases, respectively). Except with respect to acquisition financing, the functional approach should be implemented in a way that classifies all rights securing the performance of an obligation as security rights and subjects them to a common set of rules.

9. With respect to acquisition financing, the functional approach may be implemented either:
- (a) In a way that classifies as acquisition security rights all rights in movable assets that secure the payment or other performance of an obligation and that makes them subject to a common set of rules (“the unitary approach”); or
 - (b) In a way that classifies (under the approach referred to as “the non-unitary approach”):
 - (i) As acquisition security rights all rights in movable assets that secure the payment or other performance of an obligation other than the rights of a seller under a retention-of-title agreement and of a lessor under a financial lease; and
 - (ii) As ownership rights the rights of a seller under a retention-of-title agreement and of a lessor under a financial lease, but makes those ownership rights subject to rules that produce outcomes that are the functional equivalent of the outcomes produced with respect to acquisition security rights, thereby ensuring that all providers of acquisition financing are treated equally.

Party autonomy

10. The law should provide that, except as otherwise provided in recommendations 14, 15 (chapter II on the creation of a security right), 111-112 (chapter VI on the rights and obligations of the parties to a security agreement), 132-136 (chapter VIII on the enforcement of a security right), 178-186 (chapter XI on acquisition financing, option A: unitary approach), 187-202 (chapter IX on acquisition financing, option B: non-unitary approach), 203-215 and 217-227 (chapter X on conflict of laws), the secured creditor and the grantor or the debtor may derogate from or vary by agreement its provisions relating to their respective rights and obligations. Such an agreement does not affect the rights of any person that is not a party to the agreement.¹¹

Electronic communications

11. The law should provide that, where it requires that a communication or a contract should be in writing, or provides consequences for the absence of writing, that requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference.

12. The law should provide that, where the law requires that a communication or a contract should be signed by a person, or provides consequences for the absence of a signature, that requirement is met in relation to an electronic communication if:

- (a) A method is used to identify the person and to indicate that person’s intention in respect of the information contained in the electronic communication; and
- (b) The method used is either:
 - (i) As reliable as appropriate for the purpose for which the electronic communication was generated or communicated, in the light of all the circumstances, including any relevant agreement; or
 - (ii) Proven in fact to have fulfilled the functions described in subparagraph (a) above, by itself or together with further evidence.¹²

¹¹See article 6 of the United Nations Assignment Convention.

¹²For recommendations 11 and 12, see article 9, paragraphs 2 and 3, of the *United Nations Convention on the Use of Electronic Communications in International Contracts*.

II. Creation of a security right (effectiveness as between the parties)

A. General remarks

1. Introduction

1. A security right under the *Guide* is a property right (as opposed to a personal right) in movable assets (as opposed to immovable property) created by agreement (as opposed to statutory or judgement rights) between the grantor and the secured creditor (see Introduction, section B, terminology and interpretation). The property right is meant to secure the performance of an obligation owed by the grantor or another person to that creditor. When all of the steps required to make the security right effective as against the grantor have been taken, the security right is deemed to have been “created”. However, legal systems differ as to how they measure the legal impact of creation, generally taking one of three different approaches.

2. Under one approach, a properly created security right in an asset is not only effective as against the grantor, but is also automatically effective as against all third parties that claim a right in the asset (this often referred to as the *erga omnes* effect of property rights). As the fundamental point of a security right is to permit the secured creditor to sell the encumbered asset and to be paid out of the proceeds of the sale in preference to a competing claimant, under this approach there is no advantage in distinguishing between effects as between the parties and effects as against third parties.

3. Under a second approach, the security right is effective only as against the grantor, and an additional act, such as registration of a notice in a general security rights registry or delivery of possession of the asset to the secured creditor, is required to make the security right effective as against third parties claiming rights in the asset. This legal effect is referred to in the *Guide* as “effectiveness against third parties” or “third-party effectiveness”. Typically, this additional act also serves as a basis for determining the priority of the security right as against competing claimants. The second approach flows from the recognition that most legal systems impose fewer formalities for the effectiveness of contractual obligations between the parties than they do when property rights are being created. In other words, under the second approach the security agreement is sufficient to make a security right in the asset effective as between the parties, but insufficient to establish effectiveness of the property aspects of the security right against third parties, such as other secured creditors, judgement creditors, the insolvency representative in the insolvency of the grantor, or subsequent transferees of the asset. Furthermore, this approach is based on the assumption that there is no need to subject effectiveness as between the parties to notification or registration, which could create an obstacle to transactions that serve security purposes but are based on informal sale or lease techniques (such as retention-of-title sales and financial leases).

4. The legal system in a few States is based on a third approach, which is a hybrid between the first two approaches. Under this approach, a security right is treated as being generally effective against all parties upon its creation, except for other secured creditors. That is, no additional act is necessary in order for a security right to be effective as against third parties other than other secured creditors. Purchasers, lessees, licensees, judgement creditors and insolvency representatives take subject to the security right, unless some other rule of law, such as a rule protecting the purchaser of an asset in the ordinary course of business of the seller, is applicable. Nonetheless, in order to protect the right of the grantor to use its assets to secure other credit, these legal systems usually also provide that the security right is not effective as against other secured creditors unless some additional act, such as the delivery of possession or registration in a general security rights registry, takes place. That is, special rules of third-party effectiveness and priority apply to protect the rights of later-in-time competing claimants that assert specific rights in the encumbered asset. This approach generally leads to the same results as the second approach, although there might be a slight variation in relation to the rights of judgement creditors and a grantor's insolvency representative.

5. The *Guide* favours the second of the three general approaches just reviewed. There are several reasons for doing so. As between the second and third approaches, the second approach is preferable because it does not distinguish between categories of competing claimants. The *Guide* seeks to provide a comprehensive regime governing security rights, which includes principles to resolve all possible conflicts between competing claimants. Once a State takes a decision that some further step involving publicity of the security right is required for one category of claimants, it unnecessarily complicates the task of solving these conflicts if there is no common basis upon which the security right is effective against all categories of claimants.

6. As between the first approach and the second approach, the second approach is preferable because it permits States to reduce to a minimum the formalities required to create a security right. Where no distinction is drawn between effectiveness between the parties and third-party effectiveness, States will often add numerous contractual formalities aimed at protecting third parties that go well beyond what is normally required for the effectiveness of contracts between the parties to them. Conversely, in those States that require no further steps to achieve third-party effectiveness, the consequence is that third parties, including prospective secured creditors, will normally have no efficient mechanism for discovering the extent of their grantor's rights in the assets to be encumbered.

7. The *Guide* recommends an approach that distinguishes between the requirements necessary for a security right to be effective as between the parties and those additional requirements necessary to achieve third-party effectiveness of the security right against all third parties. The main objective of this approach is to facilitate the creation of a security right in an asset while at the same time giving all third parties with a right in that asset (such as purchasers, lessees, licensees, other secured creditors, judgement creditors and a grantor's insolvency representative) an inexpensive and reliable means to determine whether the grantor has encumbered that asset.

8. This chapter deals with issues relating to the creation of a security right in an asset by agreement and its effectiveness as between the parties to that agreement. The effectiveness of a security right against third parties is discussed in chapter III. The rules for the

priority ranking of creditors with claims in the same assets are discussed in chapter V. Matters related to the effectiveness of a security right in the case of the grantor's insolvency are discussed in chapter XII.

9. Section A of this chapter is devoted to describing the general principles that govern the creation of a security right. Sections A.2 to A.4 discuss the general conditions for creating an effective security right, the time when the right becomes effective between the parties, the essential elements of a security agreement and certain requirements of form. Sections A.5 to A.7 set out in greater detail observations relating to the identification of parties to a security agreement, the description of the assets that may be encumbered and the types of obligation that may be secured by a security right. Sections A.8 to A.13 address particular issues of creation in relation to proceeds, attachments and assets commingled in a mass or product.

10. Section B is devoted to a discussion of establishing effectiveness between a grantor and a secured creditor where specific types of asset are concerned. Section B.1 considers the important cases where a security right encumbers receivables and section B.2 reviews the particular situation where a receivable is assigned notwithstanding an anti-assignment clause in the underlying agreement giving rise to the receivable. Section B.3 addresses issues of creation where a receivable is itself secured by a personal or property right in other assets. Sections B.4 to B.6 set out principles to govern the creation of a security right in a right to payment of funds credited to a bank account, in a right to receive the proceeds under an independent undertaking, in a negotiable document and in assets covered by a negotiable document.

11. The chapter concludes, in section C, with a series of recommendations about the requirements for creating a security right that is effective between a grantor and a secured creditor.

2. *Creation of a security right (effectiveness as between the parties)*

12. Once a State has decided which approach to effectiveness it will adopt, it must then determine the conditions that must be met before a security right may be created and become effective as between the parties. The issues to be addressed flow from the basic structural features of a security right as a property right created by agreement to secure the performance of an obligation.

13. From this conception of a security right as a right flowing from a contractual arrangement, it follows that States must explicitly attend to five main issues. First, they must determine who may be the grantor of a security right and, in particular, whether any special limitations above and beyond those applicable to ordinary contracts should be placed on the capacity of certain persons to grant security rights. Second, they must determine who may be the beneficiary of such a right and, in particular, whether all persons with contractual capacity should be entitled to be the beneficiary of a security right. Third, they must determine what assets may be encumbered by a security right and, in particular, whether certain types of personal or business asset should be insulated from being given as security and whether whole categories of assets may be given as security. Fourth, States must determine what types of obligation may be secured by a security right and, in particular, whether future or indeterminate obligations might be secured by a security right. These issues are considered in turn in sections A.3-A.7 below.

14. In addition, some States must address some other issues when establishing rules to govern the creation of a security right and its effectiveness as between a grantor and a secured creditor. Most importantly, they must set out the precise steps that must be taken for a security right to be created and to establish the time when it is created. Then there is the question of effectiveness as between the parties generally, that is, when and under what conditions a security right becomes or ceases to be effective between the parties in respect of specific assets. Normally, these two questions have the same answer. Once all the steps necessary for the creation of a security right have been taken, it becomes effective as between the parties at that point in time. However, it may be that a security right that has been created ceases to be effective as between the parties. In such cases, it is important to determine exactly when the right has ceased to be effective as between the parties. Because these two facets of the question are independent of the content of the security agreement, they are considered first in the following paragraphs (paras. 15-25).

(a) The agreement creating the security right

15. In most legal systems, the creation of a security right in movable assets requires that an agreement between the grantor and the secured creditor providing for such creation (a security agreement) be entered into (see recommendation 13). The security agreement may fulfil several functions, including: (a) providing the legal basis for granting a security right; (b) establishing the connection between the security right and the obligation it secures; (c) generally regulating the relationship between the grantor and the secured creditor (for the rights and obligations of the parties to a security agreement, see chapter VI); and (d) minimizing the risk of disputes with respect to the terms of the agreement between the grantor and the secured creditor, including terms relating to conditions of default and enforcement (for enforcement of a security right, see chapter VIII).

16. While the security agreement sometimes may be a separate agreement between the parties, often it is contained in the underlying financing contract or other similar contract between the grantor and the secured creditor, such as a loan agreement or a contract for the sale of goods on credit. In many legal systems, the security agreement is itself sufficient to create the security right. In other legal systems, however, in addition to the security agreement, another act is required for a security right to be created (such as delivery of possession of the encumbered asset to the secured creditor or registration of a notice of the security right in a general security rights registry). What that act may be varies from State to State and even within individual States, according to the type of security right or asset involved. In order to fulfil these purposes, the security agreement must be in a language that is understandable by the grantor. Many States require that security agreements be in their official language, which may not be understandable by the grantor. Other States leave the matter to party autonomy. The *Guide* makes no specific recommendation on the language of the security agreement, although it does recommend, with regard to the notice of a security right and notices in the case of extrajudicial enforcement, that, as a general principle, a notice should be in a language that can reasonably be expected to be understood by its recipients (see chapter IV on the registry system, paras. 44-46, and chapter VIII on the enforcement of a security right, paras. 47 and 69).

17. Certain agreements relating to title to movable assets may serve security purposes. These include, for example, agreements relating to a seller's retention of title, transfer of

title for security purposes, assignment of receivables for security purposes, sale and leaseback agreements and financial leases.

18. In legal systems with a functional, integrated and comprehensive secured transactions regime, title-based devices that serve security purposes are generally required to be created in the same way as any other security right (see chapter I on the scope of application, paras. 101-114). They are either replaced by a unitary notion of a security right or, in States where forms of title-based devices are maintained, the specific requirements necessary for their creation are the same as those applicable to ordinary security rights.

19. In other legal systems, title-based devices are the main mechanism by which non-possessory security rights may be created. In such States, title-based devices are usually regulated according to the rules applicable to the specific transaction by which title is meant to pass between the parties (for example, a sale, an exchange or a lease with an option to purchase). Sometimes, given the function of title-based devices as security, the transactional rules that apply to them are also overlain with various statutory and court-developed rules. The detail of the regimes in legal systems that preserve the specificity of title-based devices can differ widely from State to State. In some legal systems, only retention of title is subject to a specific regime, while transfer of title from a borrower to a lender and assignment of receivables for security purposes are subject to the same rules governing the creation of security rights. In other legal systems, some transfer of title devices, such as a sale with a right of redemption, are also subject to a specific regime in the same manner as retention-of-title devices.

20. The treatment of retention-of-title devices is a key indicator of how a legal system generally conceives of title-based security. Legal systems that do not treat title-based devices as constituting security rights usually place particular emphasis on retention of title, even though these systems can have quite different requirements for the conclusion of retention-of-title arrangements. That is, in these systems, retention of title is used widely and is effective as against all parties upon conclusion of the relevant agreement. In other legal systems, however, retention of title plays an insignificant role and is generally ineffective as a title device, or at least ineffective as against the insolvency representative in a buyer's insolvency. One point on which many legal systems converge is that only simple retention-of-title agreements are treated as genuine title devices. Retention-of-title agreements that contain all-sums clauses (that is, clauses permitting the seller to retain title to a specific asset for all debts owed to the seller, whether they represent the purchase price of that asset or not) or proceeds and products clauses (that is, clauses purporting to extend the title of the seller in a particular asset to the proceeds and products of that asset) are, by contrast, treated as true security devices. Another point on which many legal systems converge is that only the seller may retain title. Other suppliers of credit may benefit from a retention-of-title agreement only if they receive an assignment of the outstanding balance of the purchase price from the seller.

21. The foundation of the seller's retention of title and the requirements for creating such a right vary widely among legal systems that recognize retention of title. In most of these systems, the seller's rights derive from a specific clause to that effect in the sale agreement. In a few legal systems, however, title is presumed to be retained in all sales on credit and the seller's retention right need not even be explicitly stated in the sale agreement. Some legal systems permit the contractual right of retention to be concluded between

the parties even orally or by reference to printed general terms in a supply document or invoice. In still other legal systems, some type of writing indicating a precise date for the agreement and even registration may be required.

22. Legal systems also differ substantially in the terminology used and the requirements for transfers of title for security purposes. For example, these can be called fiduciary transfers of title for security purposes, sales with a right to reclaim, double sales and sale and leaseback agreements with or without an option to purchase. Not all States give full effect to a security transfer of title. In some legal systems, a security transfer of title is void as against third parties, while in other legal systems it is occasionally held to be void even as between the transferor and the transferee. In a few legal systems, a security transfer of title is effective, but the device is not widely used in view of the existence of other non-possessory security rights. In most legal systems that recognize a security transfer of title, the rules with respect to its creation are the same as those applicable to secured transactions in general, at least if the right is to be set up against the transferor's insolvency representative. Thus, for example, a sale with a right to reclaim or a double sale will usually be subject to the same rules relating to the form and content of a security agreement.

23. Many legal systems also recognize that transactions built around the idea of a lease can often be used for security purposes. The most common transactions are hire-purchase agreements and financial leases in the context of acquisition financing and sale and leaseback agreements in the context of a lending transaction. In some legal systems, these various agreements are treated as security devices and the requirements for their creation and effectiveness as between the parties are those applicable to all other security devices. In other legal systems, they are treated not as security devices but as contractual arrangements creating personal rights. In these legal systems, the requirements for their creation are normally those applicable to the creation of a contractual right of that type.

(b) Time of effectiveness of the security right

24. The second issue that States face when deciding the basic requirements for the creation of a security right is to determine when the security right actually becomes effective between the parties. In most States, as the security right arises from an agreement between the parties, it becomes effective between them as soon as the agreement is entered into. The parties may agree to defer the effectiveness of the security right to a later time, but normally do not do so. In any case, they cannot agree to a time of effectiveness earlier than the time when they actually reach their agreement.

25. It is also necessary to determine when the security right begins to affect the particular assets that are encumbered. Here a distinction must be drawn between present assets of the grantor and future assets (that is assets that will be produced or that the grantor will acquire after the security agreement has been reached). Where the security agreement provides for the creation of a security right in assets with respect to which the grantor has rights, or the power to encumber, at the time the parties reach their agreement, the security right is effective between them in relation to those assets as of that time, unless they also agree to defer effectiveness in respect of some or all of those assets. Where, however, the security agreement provides for the creation of a security right in assets with respect to which the grantor expects to acquire rights, or the power to encumber, in the future, the

security right is effective between the parties in relation to those future assets only from the time the grantor acquires rights in them or the right to encumber them. Once again, the parties may agree to postpone the time of effectiveness past the time when the future assets are actually acquired (see recommendation 13 and paras. 51-55 below).

3. *Essential elements of a security agreement*

26. Legal systems take different positions as to the substantive elements that a security agreement must contain in order to be effective between the grantor and the secured creditor. Nonetheless, some of these elements are common to most legal systems. For example, States typically require that the security agreement must: (a) identify the parties; (b) describe the obligation to be secured; (c) describe the assets to be encumbered; and (d) clearly reflect the intention of the parties to create a security right. Some States also impose a requirement that the security agreement set out the maximum amount for which the security right may be claimed in the encumbered assets.

27. While the grantor and the secured creditor must be precisely identified, the degree of specificity required for identification of the secured obligation and the encumbered assets varies from State to State. Some States require the security agreement to contain a detailed description of individual assets to be encumbered by the security right. The advantage of a specific description is certainty, but the disadvantage is lack of flexibility to address important financing transactions involving changing amounts of secured obligations and changing pools of encumbered assets, including future assets (such as revolving credit facilities where the amount of the credit is based on the value of inventory or receivables at any given time). In any case, whether or not legislation requires the identification of the parties, the description of the obligation to be secured and the assets to be encumbered as the minimum contents of a security agreement, failure to deal with them in the security agreement may result in disputes concerning the scope of the assets encumbered and the obligation secured, unless the missing elements can be established through other means.

28. In some States, the security agreement must also set out in great detail a number of additional matters governing the relationship between the grantor and the secured creditor. These additional matters may include the duty of care on the part of the party in possession of the encumbered assets and representations with respect to the encumbered assets, the right of the grantor to dispose of encumbered assets and the duties of the grantor relating to any proceeds received from the disposition. In other States, however, these same details are not mandatory and, in the absence of a clause in the security agreement dealing with them, default rules may apply to clarify the relationship between the parties (for the rights and obligations of the parties to a security agreement, see chapter VI; for issues relating to the enforcement of a security right, see chapter VIII).

29. Many modern secured transactions regimes do not impose elaborate requirements governing the obligatory content of a security agreement necessary for its effectiveness as between the parties. Instead, they reflect the view that secured credit is best facilitated by leaving broad discretion to the parties to tailor their agreement. In order to be effective between the parties, the security agreement need set out only a minimum amount of information. Subject to the further account of these requirements in sections A.5 to A.7 of this

chapter, the *Guide* recommends that a security agreement be effective between the parties as long as it expressly confirms the intention of the parties to create a security right, specifically identifies the grantor and the secured creditor and describes the secured obligation and the assets to be encumbered (see recommendation 14).

4. Form of a security agreement

30. Legal systems also take different positions as to the requirements of form for an effective security agreement and as to the function of these requirements. In particular, some legal systems do not require that there be a written security agreement, while other legal systems require some kind of writing. In a few States, a simple, unsigned writing is sufficient. In other States, a signed writing is required. In yet other States, the security agreement must be in a notarized writing or an equivalent document. Normally, written form performs the function of a warning to the parties of the legal consequences of their agreement, of evidence of the agreement and, in the case of authenticated documents, of protection for third parties against fraudulent antedating of the security agreement. Written form may also serve other purposes besides being a condition of effectiveness as between the parties. For example, in many States it is a condition of effectiveness as against third parties and of priority among competing claimants. In many of these States, written form may also be a condition for obtaining possession of the encumbered assets or for invoking the security agreement in the case of enforcement, within or outside insolvency proceedings.

31. In some States, a certification of the date by a public authority is required for non-possessory security rights, with the exception of loans in small amounts where proof by way of witnesses is permitted. While such certification may address the problem of fraudulent antedating, it may raise a problem with respect to the time and cost required for a transaction. In other legal systems, a certified date or authentication of the security agreement is required for various types of non-possessory security right (see, for example, articles 65, 70, 94 and 101 of the Uniform Act Organizing Securities of the Organization for the Harmonization of Business Law in Africa). In some of those States, such certification is required instead of registration. Where, however, registration is necessary, an additional certification of the date of the security agreement is not required.

32. In many States, in the interest of saving time and cost, mandatory form requirements are kept to a minimum. A simple writing (including, for example, general terms and conditions on an invoice) is sufficient as long as it indicates, either alone or in conjunction with the course of conduct of the parties, the intention of the grantor to grant a security right. Consistent with the idea of simplifying the process for creating a security right as much as possible, which is one of the *Guide's* key objectives, this is the position recommended in the *Guide* (see recommendations 1, subparagraph (c), and 15). Writing includes an electronic communication (see recommendation 11).

33. Many States that generally require the security agreement to be concluded in or evidenced by a writing permit an exception where the agreement between the parties is accompanied by a transfer of actual possession of the encumbered asset to the secured creditor. In this case, the security agreement may be oral. The *Guide* recommends this approach (see recommendation 15). However, if the security right is created by an oral

agreement and transfer of possession and later the secured creditor wishes to relinquish possession, a written agreement will be necessary for the security right to continue to exist after possession is given back to the grantor (for the implications of this matter with respect to third-party effectiveness see chapter III on the effectiveness of a security right against third parties, paras. 120-122, 157 and 158).

5. Parties to a security agreement

34. A security agreement is an agreement between a grantor and a secured creditor. As the potential outcome of the creation of a security right is that the secured creditor may seize and dispose of the encumbered assets, most States consider the creation of a security right to be an act of disposition. For this reason, they require the grantor of the security right to have the legal capacity to alienate the asset in which the security right is created. In the case of natural persons, this implies that rules respecting minors and those with diminished capacity will be fully applicable. In respect of businesses, it means that by-laws relating to borrowing and similar restrictions will apply.

35. Some States impose additional limitations on the power of certain persons to create certain kinds of security right, but these further limitations normally relate to the types of asset that may be encumbered by the grantor or the types of security right that may be created in these assets. The *Guide* takes the position that, except to the extent that States provide for limitations on the capacity of grantors to alienate assets in their general law, there should be no restrictions on the capacity of grantors to create a security right in their movable assets (see recommendation 2, subparagraph (b)).

36. In most cases, the grantor of the security right will also be the debtor of the obligation that is being secured, but this need not necessarily be the case. Many States permit a third person to create a security right in its assets for the benefit of a debtor. For example, parents may grant a security right in their assets in order to secure an obligation contracted for by their child or, more commonly, a parent company may create a security right in its assets to secure the obligation of its subsidiary. In these cases, it is the third person rather than the debtor of the secured obligation that is the grantor under the security agreement and that must possess the required capacity. In other words, it may be that the debtor has the capacity to incur the obligation, but does not have the capacity to create the security right. Moreover, even if a debtor has the capacity to grant security over its own assets, if a third party who desires to create a security right in its assets does not have such capacity, the security right cannot be created.

37. As to who may be a secured creditor, several approaches have traditionally been taken. Some States consider security rights to be exceptional and limit the category of creditors that may benefit from them. For example, in some cases, banks are permitted to take security, but other lenders (credit unions, insurance companies, pension funds and private lenders) are not authorized to do so. In other States, certain types of security right can only be taken by certain types of creditor (for example, security taken by lenders, landlords or shippers). More recently, most States have opted for regimes that provide for a level playing field for all types of creditor. Allowing all providers of credit to take security on equal terms facilitates genuine competition for credit based on price and reduces the cost of credit for grantors. Moreover, in many complex transactions when large loans are granted collectively by several lenders (for example, syndicated loans), the creditor under

the security agreement may not be the only lender or a lender at all, but rather a third party acting as agent or trustee and holding the security right on behalf of all the lenders. Consistent with its aim to promote secured credit, the *Guide* takes the position that there should be no restrictions on the types of creditor that can obtain a security right. For example, domestic and foreign lenders, banks, insurance companies, pension funds and other lenders should have the same rights and no form of security should be available to only one particular type of creditor (for example, a seller or a lessor) to the exclusion of other types of creditor (for example, a lender) (see recommendation 2, subparagraph (b)).

6. *Obligations secured by a security agreement*

38. Security rights are accessory to and dependent upon the obligation they secure. This means that the validity and the terms of the security agreement depend on the validity and the terms of the agreement establishing the secured obligation. With respect to revolving loan transactions in particular, a security right is accessory in the sense that, although it can secure future advances and fluctuating obligations, it cannot be enforced if there is no advance on the loan. Moreover, once the loan has been made, it cannot be enforced for an amount greater than the obligation actually owed at the time of enforcement.

39. In some legal systems, non-possessory security rights may relate only to specific types of obligation described in legislation (such as loans for the purchase of automobiles or loans to farmers). In States with a general regime for both possessory and non-possessory security rights, no such limitations exist. Such a comprehensive approach has the potential to spread the main benefits derived from secured financing (that is greater availability and lower cost of credit) to a wider range of transactions. In addition, such an approach enhances consistency and equal treatment of all debtors and secured creditors. To the extent such special regimes are necessary for specific socio-economic reasons, adverse effects may be minimized if such regimes are established in a clear and transparent way and are limited to a narrow range of transactions.

40. Legal systems that do not link certain forms of security rights to certain types of obligation typically do not limit the types of obligation for which a security right may be created. Moreover, unless there is a special regime for security rights in specific types of obligation (for example, for loans made by pawnbrokers), States usually do not list in legislation all the types of obligation that may be secured. Given the fast pace at which new types of credit obligation are being created, it would be impossible to enact an exhaustive list that would not quickly be out of date. It is, however, common for States to provide an indicative list. Such a list would typically include obligations arising from loans and the purchase of goods, including inventory and equipment, on credit.

41. Legal systems take different positions on whether and to what extent a security agreement may be created to secure conditional as well as unconditional obligations. In many States, all conditional obligations may be secured, but in other States only obligations subject to a condition that arises subsequently may be secured by a security right. Moreover, legal systems also differ as to whether a secured obligation must be determinate or whether it merely needs be determinable. Finally, States have taken different positions on whether and to what extent a security agreement may be created to secure future obligations. They also differ on the definition of what a future obligation actually is. In

some systems, future obligations are obligations that arise from a contract that the parties have not yet agreed to. In other systems, even obligations that have been contracted for but are not due at the time the security agreement is entered into (because the loan has not yet been disbursed to the borrower or the loan involves a revolving loan facility) are treated as future obligations.

42. The distinction between present and future obligations is significant in those legal systems in which, for reasons of certainty and debtor protection, future obligations are not capable of being secured or may be secured only up to a maximum amount or may not be secured if they are indeterminate (for example, where the security agreement purports to cover “all present and future obligations of whatever type that may arise between the parties”). In legal systems that impose limits on granting security rights to secure future obligations, debtors may not be able to avail themselves of certain transactions, such as revolving loan facilities or convertible term loans. In other legal systems, future obligations may be freely secured. In these systems, one security agreement is sufficient to cover both present and future obligations. As a result, each extension or increase of credit does not require that the corresponding security right be modified or even created anew, and this is likely to have a positive impact on the availability and the cost of credit. It should be noted that, although a security right may be created to secure a future obligation, the security right cannot be enforced until the obligation arises and is in default.

43. Legal systems impose various requirements as to the manner in which the type and amount of the secured obligation must be expressed in the security agreement. In some legal systems, it is necessary for the parties to describe the secured obligations in specific terms. Sometimes, it is also necessary to set a maximum limit on the amount for which the asset can be encumbered as security for the secured obligation, or even to reduce the amount of the secured obligation to reflect the current balance owed on that obligation. The assumption is that such a description or limit is in the interest of the grantor, since the grantor would be protected from over-indebtedness. Moreover, stipulating a maximum amount for which the security right can be enforced enables the grantor to provide an ironclad guarantee to other creditors as to the amount of unencumbered equity it has in the encumbered assets. In consequence, the grantor would have greater flexibility in seeking additional secured credit from another lender based on the same assets. However, such requirements may result in limiting the amount of credit available from the initial creditor or may lead creditors to indicate an amount well in excess of the actual amount that they agree to advance to the grantor. If this turns out to be the case, then the result may be that the grantor is deprived of the ability to use the full value of its assets to obtain additional credit from its present creditor or new credit from other creditors.

44. In the past, most lending transactions involved a one-time disbursement of credit. For such types of financing, the position taken in many legal systems that a grantor could reduce, with each payment it makes, the maximum amount for which the security right was granted does not cause great difficulty. However, modern financing transactions are often no longer of this type. Instead, they frequently foresee disbursements being made at different times depending on the needs of the grantor (for example, revolving credit facilities for the grantor to buy inventory). Such financing may be conducted on the basis of a current account, the balance of which fluctuates daily. If the indicated maximum amount of the secured obligation were to be reduced by each payment made by the grantor, lenders would be discouraged from making further disbursements unless they were granted

additional security. This result would be highly inefficient as it would add to the cost and the time necessary for the grantor to acquire new assets required for the conduct of its business. For this reason, States that require the security agreement to contain a statement of the maximum amount should not also require the indicated amount to be reduced as payments are made.

45. Finally, a few legal systems attempt to control credit by imposing limits on the amount for which an asset may be encumbered, calculated on the basis of a formula. For example, the maximum amount may be fixed as a percentage of the credit advanced to the grantor (such as 125 per cent of the initial obligation owed or of the maximum amount permitted under a line of credit or of the amount outstanding at any given time). These types of *ex ante* legislative limit as to the amount to be secured are unavoidably arbitrary and usually cannot be fine-tuned to meet the credit needs of individual grantors. Moreover, in the case of fluctuating obligations, they would normally need to be adjusted constantly to reflect changes in the credit relationship between the grantor and the secured creditor. Again, however, these criticisms do not apply in cases where the parties to the security agreement may freely negotiate a maximum amount for which the asset is encumbered and where this amount remains fixed, even though the amount owing under the secured obligation diminishes or fluctuates.

46. For all of the above-mentioned reasons, many legal systems (including legal systems that require the security agreement to state a maximum amount for which the assets are encumbered) do not require specific descriptions of the secured obligations, allowing the parties to negotiate freely the amount to be secured. In these legal systems, the secured obligation may be present or future, conditional or unconditional and determined or determinable on the basis of the security agreement or the records maintained by the parties whenever a determination is needed (as is the case, for example, at the time when the secured creditor enforces its security right). Similarly, the secured obligation may be fixed or fluctuating and may include all sums owed by the debtor to a secured creditor. Given the objective of facilitating secured credit, the *Guide* recommends this broad approach to the obligations that may be secured by a security right (see recommendation 16).

47. States also take different positions as to whether the actual amount of the secured obligation (including the rate of interest or other cost of the credit) must be stated in the security agreement itself and whether that amount must be expressed in a currency and, if so, in what currency it must be expressed. For example, some States require that the security agreement indicate not only the type of obligation being secured but also its amount (that is the actual amount of the credit being provided). Other States require only that the type of obligation be stated and leave the details to the loan or credit agreement. In addition, some States require the obligation to be expressed in a currency (for example, €100,000 or \$200,000), while others permit the parties to express the repayment obligation however they wish (for example, 500,000 ounces of gold). At the beginning of the twenty-first century, many States do not impose any restrictions on the currency in which the amount of the secured obligation may be expressed beyond those applicable to obligations generally.

48. Where there is debtor default (or insolvency) and disposition of the encumbered assets, the proceeds may be paid in a currency (for example, United States dollars)

different from the currency (for example, Euros) in which the secured obligation is expressed. In such cases, it will be necessary to convert the proceeds from the disposition of the encumbered assets so that the secured obligation and those proceeds are expressed in the same currency. The exchange rate, however, is typically left to the contract from which the secured obligation arises and to the applicable law (for example, in the absence of an agreement, the exchange rate prevailing at the place of enforcement or insolvency proceedings will prevail).

7. *Assets subject to a security agreement*

49. A central aspect of the security agreement is the identification of the assets that will be encumbered by the security right. States typically are required to address four separate issues when determining how the assets to be encumbered by the security right should be identified. The first is whether a security agreement may provide for the creation of a security right in assets not owned, or not yet owned, by the grantor. The second is whether certain types of asset should not be permitted to be encumbered by a security right. The third is how the assets may be described (whether they must be described individually or may be described generically). Finally, States have to decide whether a grantor should be permitted to create a security right that generally covers all its assets (that is, a security right that in many States takes is known as an “enterprise mortgage” or a “floating charge”).

50. Before examining these four issues, it is important to underline a fundamental point. All States take the position that, when the parties to a security agreement specify the asset to be encumbered by the security right, they intend the asset to be encumbered to the full extent of the grantor’s rights in the asset. Thus, for example, if the security agreement encumbers a piece of equipment that the grantor owns, it is the grantor’s full right of ownership that is encumbered. Should the value of the asset increase during the period of the security agreement, the asset remains encumbered for its full value up to the amount of the outstanding obligation. Consistent with the principle of party autonomy (see recommendation 10), it is always open to parties to provide in their agreement that the asset will be only partially encumbered (for example, only to the extent of an undivided 50 per cent interest) or that the asset will be encumbered only for a limited amount (for example, only to the value it had at the time the security right was granted). However, unless the parties specifically provide otherwise, the security right encumbers the entirety of the asset, the entirety of the grantor’s rights in the asset and the entirety of the value of the asset at the time that it becomes necessary to enforce the security right.

(a) *Future assets*

51. In most legal systems, the grantor of the security right has to be the owner of the assets to be encumbered or have some limited property right (such as a right of use) in the assets. That is, the security agreement cannot be entered into until the grantor actually has rights in the assets that the agreement purports to cover. This immediately raises the question as to whether the security agreement can cover: (a) assets in which the grantor has only a contractual right (for example, in many legal systems a lessee has no property rights in a leased asset); and (b) future assets (namely assets that the grantor acquires or assets that arise after the security agreement is entered into).

52. In addressing these issues, most legal systems start from the principle that the grantor cannot grant to the secured creditor more rights than the grantor has or may acquire in the future (*nemo dat quod non habet*). This means that, if the grantor has only a contractual right to use an asset, any security right that it grants can only encumber its contractual right of use. Thus, for example, a lessee may only create a security right in its rights as a lessee under a lease agreement and not directly in the asset being leased. Subject to rules that States adopt concerning the details required for describing the encumbered asset in the security agreement, this means that the security agreement must identify the asset as the grantor's rights as lessee under a lease, not as the leased asset itself. Similarly, it means that, if the grantor has only a limited right in the asset (for example, a usufruct), the security right will only encumber the right of usufruct.

53. Increasingly, legal systems are confronted with the question of whether future assets may be covered by a security agreement. In some legal systems, no future assets of any kind may be used as security. This approach is partly based upon technical notions of property law (for example, what does not exist cannot be transferred or encumbered). It is also based on the concern that allowing broad dispositions of future assets may inadvertently result in over-indebtedness and in making the grantor excessively dependent on one creditor, precluding the grantor from obtaining additional secured credit from other sources. Another argument offered for prohibiting the creation of security rights in future assets is that, if such rights were permitted, this might significantly reduce the possibility that unsecured creditors of the grantor will obtain satisfaction of their claims. However, technical notions of property law should not be invoked to pose obstacles to meeting the practical need of using future assets as security to obtain credit. In addition, business grantors can protect their own interests and do not need statutory limitations on the transferability of rights in future assets. Moreover, permitting future assets to be encumbered makes it possible for grantors with insufficient present assets to obtain credit, which is likely to enhance their business and benefit all creditors, including unsecured creditors. To the extent that certain grantors may need protection against unwise encumbering of future assets, this should be a matter to be addressed in other law, such as consumer protection law.

54. In other legal systems, the parties may agree to create a security right that will encumber a future asset. In such cases, the security right is created at the time of the agreement between the parties, but the security right does not actually encumber the asset until the grantor becomes the owner of the asset or the asset comes into existence. The United Nations Assignment Convention takes this approach (see article 8, paragraph 2, and article 2, subparagraph (a)). Permitting the use of future assets as security for credit is important, in particular, for securing claims arising under revolving loan transactions secured by a revolving pool of assets. Assets to which this technique is typically applied include inventory, which by its nature is to be sold and replaced, and receivables, which after collection are replaced by new receivables. The main advantage of this approach is that one security agreement may cover a changing pool of assets that fit the description in the security agreement. Otherwise, it would be necessary continually to amend security agreements or enter into new ones, a result that would increase transaction costs and decrease the amount of credit available, in particular in the case of revolving credit facilities.

55. The *Guide* recommends that a security agreement may cover future assets. Where the security agreement provides for the creation of a security right in assets with respect

to which the grantor has rights or the power to encumber at the time the security agreement is entered into, the security right in those assets is created at that time. Where, however, the security agreement provides for the creation of a security right in assets with respect to which the grantor expects to acquire rights or the power to encumber in the future, the security right is created if and when the grantor acquires such rights or power to encumber (see recommendations 13 and 17).

(b) Excluded assets

56. In some legal systems, special laws for specific types of security right introduce limitations as to the types of asset that may serve as security or as to the part of the value of assets that may be encumbered. An example of a limitation justified for public policy reasons would be one preventing the creation of a security right in employment benefits (for example, wages and pensions) under a certain minimum amount. In other legal systems, limitations are placed on the purposes for which certain classes of grantors may create a security right in their assets. For example, grantors may not be permitted to create a security right in household goods unless the security right is created to secure payment of the purchase price of those assets. In still other legal systems, certain grantors have limited capacity to create certain types of security right. For example, in some legal systems persons not carrying on a business may be prevented from granting non-possessory security rights and may only grant possessory (pledge-type) security rights. Similarly, these same persons may not be permitted to grant a security right in future assets or a security right in a category of assets. That is, they may grant security rights only in their existing assets and only where those assets are described individually.

57. All of these limitations, which are usually intended to protect grantors, also have the unintended result of preventing grantors from utilizing the full value of their assets to obtain credit. Therefore, the positive and negative impacts of such limitations need to be carefully weighed. Some legal systems undertake this balancing not by including such limitations in the general legislation establishing the regime of security rights, but by elaborating specific rules setting out appropriate limitations on the creation of security rights in special legislation (such as consumer protection legislation). This approach has the advantage of enabling States to design the limitations in a targeted manner that furthers policy objectives directly related to the protection of those grantors deemed to be in need of such protection.

(c) Identification of assets in the security agreement

58. In some legal systems, the encumbered assets need to be specifically identified in the security agreement. While such a requirement is intended to protect the grantor from overcommitting its assets to secured creditors, it also limits the availability of secured credit in many cases. For example, specific identification of individual items may not be practical or even possible for assets such as inventory and, to some degree, receivables. To address this issue, many legal systems have rules that allow the parties to describe the assets to be encumbered in general terms. The specific identification that is typically required is transposed from the individual items to an aggregate, which in turn has to be sufficiently identified.

59. These descriptions of categories of assets can take various forms. For example, parties may provide that the security right encumbers “all inventory”, “all inventory in warehouse number 2”, “all sailboats and canoes”, “all printing presses” or “all receivables”. The key is neither the type of asset (equipment, inventory, receivables) nor the extent or scope of the category (“all assets in location ABC” or “all sailboats and canoes” as opposed to “all watercraft”). Rather, legal systems that permit general descriptions simply require that the description in the security agreement be sufficient to enable all interested parties to reasonably identify, at any given time, what assets are encumbered under the security agreement.

60. In some legal systems, it is possible to identify encumbered assets with a description cast at a very high level of generality. In these legal systems, even a description referring to “all assets” or “all present and future assets” is sufficient. The goal is to reduce the complexity and cost of creating a security right by permitting the parties to describe the encumbered assets in the simplest language possible. As noted, however, in many legal systems that permit identification by reference to a category of assets, such a general identification of encumbered assets is not allowed where the grantor is a consumer or even an individual small trader. The *Guide* recommends that a security agreement must describe the encumbered assets in a manner that reasonably allow their identification (see recommendations 14, subparagraph (d), and 17). This means that, subject to ensuring that the identification of encumbered assets is sufficiently clear and adheres to public policy limitations that States may desire to impose to protect consumers, general descriptions of both present and future assets are sufficient.

(d) Security rights in all assets of a grantor

61. As mentioned above, some legal systems do not permit grantors to create a security right in assets that are described in general terms. By contrast, many other legal systems do. Nonetheless, even in some legal systems that permit the general identification of categories of encumbered assets and even permit a general identification of categories of present and future assets, grantors are often not permitted to create a security right in all of their assets (that is by means of a super-general description such as “all present and future assets”). In other legal systems, grantors are permitted to create a security right in all of their assets, but only up to a certain percentage of their total value. Such limitations, which are intended to provide some protection for grantors and unsecured creditors, usually end up limiting the credit available to debtors and increasing its cost.

62. By contrast, some legal systems impose no limitations on the scope of a security right. Grantors are permitted to create a non-possessory security right in all of their assets, including tangible and intangible assets, movable assets and immovable property (although different rules may apply to security in immovable property) and present and future assets. The most essential aspects of such an all-asset security right are, first, that it covers all assets of a grantor in a single security agreement and, second, that the grantor has the right to dispose of certain of its encumbered assets (such as inventory) in the ordinary course of its business (with the security right being extended automatically to the proceeds of the disposed assets). Legal systems take different approaches as to both of these aspects of all-asset security rights.

63. In many legal systems, the essential elements, both as to content and as to form, for the creation of a security right covering all assets are more onerous than those applicable to ordinary security rights. In other legal systems, as long as no immovable property is encumbered by the security agreement, the requirements for creating the security right are identical to those for ordinary security rights in movable assets. Where immovable property is also encumbered, it is necessary that the agreement respect the substantive and formal requirements for creation of an encumbrance on immovable property. As for the grantor's right to dispose of encumbered assets notwithstanding the security right, most legal systems provide that the grantor may do so with the authorization of the secured creditor. Some legal systems provide that, in such cases, the security right no longer encumbers the asset, while others provide that the security right still encumbers the asset. However, in some legal systems, dispositions of encumbered assets by the grantor, even if authorized by the creditor, are regarded as irreconcilable with the idea of a security right. In order to simplify the creation of a security right in all assets of an enterprise, where the provider of credit is financing the ongoing operation of the enterprise the *Guide* recommends that single-document, all-asset security agreements be permitted (see recommendation 17).

(i) *Enterprise mortgages*

64. The concept of "all-asset security rights", as recommended in the *Guide*, is not novel. In some States, the idea of an all-asset security right has long existed in the form of what is often called an "enterprise mortgage". Like an all-asset security right, an enterprise mortgage may encumber all assets of an enterprise (sometimes including even immovable property). It may cover, for example, incoming cash, new inventory and equipment and future assets of an enterprise. The security agreement creating an enterprise mortgage normally provides that present inventory that is disposed of in the ordinary course of business is released from the encumbrance. The main advantage of an enterprise mortgage is that it allows an enterprise that has a high value as a whole to obtain more credit and at a lower cost.

65. An interesting feature of some forms of enterprise mortgage is that, upon enforcement by the secured creditor or another creditor, an administrator can be appointed for the enterprise. This may assist in avoiding liquidation and in facilitating reorganization of the enterprise with beneficial effects for creditors, the workforce and the economy in general. Sometimes, however, administrators appointed by the secured creditor may favour the secured creditor. This problem may be mitigated to some extent if the administrator is appointed and supervised by a court or other authority. This enforcement feature of an enterprise mortgage might usefully be expanded to all-asset security rights. In other words, a secured transactions law might provide for the appointment of an administrator either by agreement of the grantor and the secured creditor or by the court. The administrator would then be responsible for enforcing the security right outside insolvency and, subject to insolvency law, even in the case of insolvency.

66. However, enterprise mortgages may present certain disadvantages in practice. One disadvantage is that the secured creditor usually is or becomes the enterprise's major or even exclusive credit provider. In order to address this issue, some States have introduced limitations on the scope of enterprise mortgages, preserving a percentage of the value of the enterprise for unsecured creditors in the case of insolvency. Such a limitation though

(often referred to as a “carve-out”) may have an adverse impact on the availability of credit by effectively reducing the assets available to serve as security for credit. Another possible disadvantage of enterprise mortgages is that, in practice, the holder of the mortgage may fail to monitor the enterprise’s business activities sufficiently or to participate actively in reorganization proceedings since the mortgagee is amply secured. In order to counterbalance the mortgagee’s overly strong position, the debtor-enterprise may be granted a claim for the release of grossly excessive security.

(ii) Fixed and floating charges

67. In other States, all-asset security takes the form of a combination of a fixed and a floating charge. The secured creditor is granted a “fixed charge” on those assets (such as equipment) that the grantor may not dispose of without the consent of the secured creditor. On the other hand, the secured creditor is given a “floating charge” on those assets with respect to which the grantor is given the right to dispose (such as inventory) in the ordinary course of its business. Dispositions are barred as of the time the debtor is in default, when the floating charge crystallizes to become a fixed charge. Fixed and floating charges may encumber all or substantially all of the assets of an enterprise. The relevance of the distinction usually is that the floating charge is subject to certain priority claims in favour of other creditors or to a carve-out in favour of unsecured creditors generally, while a fixed charge is not.

(iii) Over-collateralization

68. Related to but distinct from concerns about all-asset security rights is the issue of over-collateralization. The problem of over-collateralization arises in situations where the value of the encumbered assets significantly exceeds the amount of the secured obligation. While the secured creditor cannot claim more than the secured obligation plus interest and expenses (and perhaps damages upon default), over-collateralization may create problems. The grantor’s assets may be encumbered to an extent that makes it difficult or even impossible (at least in the absence of a subordination agreement between creditors) for the grantor to obtain secured credit from another creditor granting a second-ranking security right in the same encumbered assets. In addition, because all the assets of a grantor are encumbered, enforcement by the grantor’s unsecured creditors may be precluded or at least be made more difficult, unless there is clearly identifiable value remaining after the satisfaction of all the secured obligations.

69. Courts have developed various solutions to this problem. One solution is to declare void any security right that encumbers the value of an asset to an extent that is grossly in excess of the secured obligation plus interest, expenses and damages. Another solution is to give the grantor a claim for release of such excess security. A third solution is to require the secured creditor to negotiate in good faith with the grantor, at the grantor’s request, for the release of some of the excess security. This solution could work in practice, if a commercially adequate margin could be determined and granted to the secured creditor, which may not be easy in all cases. While the problem of over-collateralization is a real concern, the appropriate response to the concern is likely to vary from State to State and may sometimes lie in regulation of these practices in other law. For this reason, the *Guide* does not

recommend that courts be given the authority to declare a security right void or to reduce the scope of a security right by means of a judicial declaration of over-collateralization.

(iv) *Conclusion*

70. Once a legal system permits, as recommended in the *Guide* (see recommendation 17), the creation of non-possessory security rights in all present and future assets of a grantor under a regime that also allows the grantor to dispose of certain of the encumbered assets in the ordinary course of its business, many of the specific devices that States have designed to permit businesses to obtain credit by granting security rights over the enterprise as a whole may no longer be necessary. That is, in many legal systems, concepts and terms such as “enterprise mortgage” and “fixed and floating charge” have been important because they performed a role in business financing that regular security rights were not able to accomplish. However, where States opt to create a functional, integrated and comprehensive regime for the granting of non-possessory security rights and also to enable grantors to encumber all their present and future assets in the same agreement, the need for these existing devices is significantly reduced, if not eliminated. While the *Guide* does not recommend that States dispense with enterprise mortgages and fixed and floating charges, it does recommend that States adopt the concept of an all-asset security right, a concept that performs the same functions as these traditional devices (see recommendation 17).

(e) *Liability of the secured creditor for loss or damage caused by encumbered assets*

71. While liability for loss or damage caused by encumbered assets (as a result of breach of contract or wrongful act) is not an issue related to secured transactions, it is important that it be addressed since it may have an impact on the availability and the cost of credit. A particularly important issue is liability for environmental damage caused by encumbered assets, since the monetary consequences and the prejudice to the reputation of the secured creditor may substantially exceed the value of the encumbered assets. Some laws expressly exempt secured creditors from liability, while other laws limit such liability under certain conditions (for example, where the secured creditor has no possession or control of the encumbered asset). When no such exemptions from or limitations of liability exist, the risk may be too high for a secured creditor to extend credit. Moreover, where insurance is available, it is likely to be expensive and therefore is bound to increase substantially the cost of credit. In enacting a secured transactions law, States will have to decide how to balance these competing considerations in a manner that does not have a negative impact on the availability and the cost of secured credit.

8. *Creation of a security right in proceeds*

(a) *Scope of a security right in proceeds*

72. A legal system governing security rights must address two distinct questions with respect to proceeds. The first issue only arises where the grantor actually disposes of the assets encumbered by the security right. The question is whether the secured creditor

retains the security right if the encumbered asset is transferred from the grantor to another person (or, in other words, whether the secured creditor is entitled “to follow” the encumbered asset in the hands of the transferee) in the transaction that generates the proceeds. Strictly speaking, this is not a question that relates to proceeds. Rather, it relates to the scope of third-party effectiveness of a security right. The *Guide* recommends that a security right normally continues to be effective against a transferee to whom the grantor transfers the encumbered asset (see recommendations 31 and 79 and chapter III on the effectiveness of a security right against third parties, paras. 15-18, as well as chapter V on the priority of a security right, paras. 60-89).

73. The second issue concerns the secured creditor’s rights with respect to the proceeds from the disposition of the encumbered asset. Some legal systems do not give secured creditors an automatic right in proceeds, regardless of whether these are natural and civil fruits or revenues, products of manufacture or proceeds of disposition. The security agreement must explicitly extend the security right to these proceeds. Other legal systems give a secured creditor a right in natural and civil fruits or revenues, but only when the secured creditor is in actual possession of the original encumbered asset. Still other legal systems give an automatic right in all natural and civil fruits or revenues and products of manufacture, but not in proceeds of disposition. The reason is that the creditor’s security right is in the original encumbered asset and that the secured creditor can be adequately protected as long as it can claim a right to follow. A few legal systems adopt this general position, but provide that, if the secured creditor loses its right to follow the encumbered asset in the hands of a transferee, by operation of the concept of real subrogation, the lost security right may be transferred into the proceeds of disposition (for example, in many legal systems, the purchaser of movable assets in the ordinary course of business of the seller may acquire encumbered assets free of any security right). Finally, many legal systems provide that the security right automatically passes into proceeds of all types, including proceeds of proceeds, even in cases where the secured creditor may still claim a security right in the original encumbered asset that has been sold.

74. The justification for a security right in proceeds is said to lie in an extrapolation of the expectations of the parties. First, the secured creditor normally expects to have a security right not only over the asset itself, but over all that the asset produces or generates including natural and civil fruits or revenues. Second, the secured creditor normally expects the grantor not to dispose of an encumbered asset without the secured creditor’s authorization. If the secured creditor does not obtain a right in proceeds, an unauthorized disposition of the original encumbered assets could defeat or sharply reduce its ability to rely on those assets to secure the debt. This would be true even in cases where the security right in the original encumbered assets survives their disposition to a third party. The reason is that an unauthorized transfer of the encumbered assets is likely to increase the difficulty in locating the assets. These issues merit further analysis.

75. To discuss first the classic case of proceeds of disposition, if the secured creditor’s right in proceeds is a property right, the secured creditor will not suffer a loss by reason of a disposition or other similar event, since a property right produces effects against third parties. On the other hand, granting the secured creditor a property right in proceeds might result in frustrating legitimate expectations of parties that obtained security

rights in those proceeds as original encumbered assets. However, in legal systems in which creation is distinguished from third-party effectiveness, this result would occur only if the creditor with a property right in proceeds is able to maintain its priority over the creditors claiming a right in those assets as original encumbered assets. Thus, in those systems, potential financiers are forewarned about the potential existence of a security right in assets of their potential borrower (including proceeds of such assets) and can take the necessary steps to identify and trace proceeds and to obtain subordination or other inter-creditor agreements where appropriate.

76. A slightly different analysis is necessary in cases where the proceeds in question are not proceeds of disposition, but are natural and civil fruits or revenues, or the products of manufacture. In the last case, parties would normally expect that raw materials would be used in a manufacturing process. The policy question is, consequently, whether a State should adopt a rule that requires a security agreement to provide explicitly that the security right is taken not only in the raw materials but also in any product that is manufactured from those raw materials. Alternatively, the assumption could be that, as raw materials will normally be transformed into manufactured products, the resulting products should automatically be covered by the security right unless the security agreement provides to the contrary. Most States do not require parties to specify that the security right extends to products manufactured from raw materials, as long as the products can be clearly identified as having resulted from those raw materials.

77. Many legal systems require parties to state in the security agreement whether natural fruits are covered by the agreement. Other legal systems provide that natural fruits are automatically covered unless the parties provide otherwise. In keeping with the general orientation of the *Guide* to provide recommendations that are consistent with the normal practice of parties to financing transactions, the approach adopted is to consider natural fruits to be proceeds and thus to be automatically covered as proceeds by the security right in the original encumbered assets (see the term “proceeds”, which includes natural fruits, Introduction, section B, Terminology and interpretation).

78. Finally, as concerns civil fruits or revenues, reasons of economic efficiency normally would suggest that a security right in a claim for the payment of capital (such as a negotiable instrument or receivable) should also embrace a right to the interest that is payable. This is because payments on negotiable instruments and receivables are often blended payments of capital (principal) and interest. Only where it is easy to distinguish the payment of capital from the payment of interest and where the parties agree that the security right in the capital does not extend to the accrued interest, should the law permit the interest to be severed from the principal obligation. Where the revenues flow from the lease or licence of an original encumbered asset the same result follows. The parties expect that certain types of asset will be used to produce revenue and that in doing so the asset is likely to depreciate in value. Permitting the security right to cover rental payments is logical since, from an economic point of view, they are the return the grantor receives against the depreciation of the original encumbered asset. Once again, because the *Guide* is designed to make recommendations that reflect the normal practice of parties to financing transactions, it recommends that civil fruits or revenues should be treated in the same way as proceeds and thus be automatically covered by the security right in the original encumbered asset; see recommendation 19).

(b) *Creating a security right in proceeds*

79. The discussion in the immediately preceding paragraphs shows that there are practical reasons why many legal systems extend security rights in encumbered assets to various forms of proceeds (including proceeds of proceeds) through rules applicable in the absence of an agreement to the contrary. In other legal systems, where an automatic right in proceeds does not exist, whether in respect of proceeds of disposition or in relation to one or more categories of natural and civil fruits or revenues, or manufactured products, parties are typically permitted to specify that they will take security rights in all types of asset as original encumbered assets. In such systems, parties may be free to provide, for example, that a security right is created in substantially all of the grantor's assets (cash, inventory, receivables, negotiable instruments, securities and intellectual property). In such a way, the proceeds themselves become original encumbered assets and are covered by the security right of the creditor even without a legal rule automatically providing a right in proceeds. In a few of those legal systems, parties may also extend by agreement certain title-based rights (for example, retention-of-title rights) to proceeds.

80. Regardless of whether a right in proceeds flows automatically from a right in the original encumbered assets or whether it must be explicitly mentioned in the security agreement, there are no additional formalities imposed on parties that seek to claim a right in any of these forms of proceeds. The only requirement is that, in the latter case, the security agreement should specify a right in the proceeds and indicate the kinds of proceeds that are meant to be included in the same security right, while in the former case, it is sufficient to identify clearly the original encumbered assets.

81. Even when the security right automatically extends to proceeds, the parties may stipulate in the security agreement that the security right does not extend to specified types of proceeds or all proceeds generally. The principal reason for providing in the law for an automatic extension of the security right to proceeds is that this is consistent with the usual expectations of the parties. In line with its general objective of facilitating secured credit, the *Guide* takes the position that the secured transactions regime should adopt rules that minimize the need for parties to state explicitly what will be the normally desired outcome. The principle of party autonomy (see recommendation 10) sufficiently protects parties that wish to limit the security right to original encumbered assets. The *Guide*, therefore, recommends that a security right in encumbered assets automatically extends to their identifiable proceeds without the need for parties to provide so in their security agreement (see recommendation 19).

(c) *Extent of a security right in proceeds*

82. Where the security right automatically passes into the proceeds, it is necessary to determine the extent to which the security right may be claimed in these proceeds. In the case where the proceeds are in the form of natural and civil fruits or revenues, the proceeds are additional encumbered assets and it is logical that the security right may be claimed in them even if this should result in the secured creditor being able to claim the security right in assets that have a greater overall value than the original encumbered asset.

83. In some States, additional policy concerns are present, however, where the proceeds are proceeds of disposition of the original encumbered assets by the grantor or other person in possession. Three approaches are possible. Some States provide that the secured creditor must elect whether to enforce its rights in the original encumbered assets or in the proceeds. The *Guide* does not adopt this position since the right in proceeds is meant to protect the secured creditor from post-disposition physical deterioration or loss of value of the original encumbered assets.

84. Other States provide that the security right may be enforced up to the value of the original encumbered assets at the time of the disposition. For example, if the asset was worth €1,000 when it was sold, but the proceeds are worth €1,500, the automatic security right in the proceeds is limited to €1,000. Likewise, in this example, should the creditor realize €400 from the sale of the original encumbered asset, it may only claim a maximum of €600 from the proceeds. The policy rationale for this result is that the proceeds right is meant to protect the secured creditor against post-disposition physical deterioration or loss of value of the original encumbered assets and not to give the secured creditor an unexpected windfall at the expense of other creditors. Should the parties wish to realize upon the proceeds to the full extent of the outstanding obligation, they would be able to do so by including the type of asset received as proceeds in the description of the original encumbered assets in the security agreement (and by having the notice registered, if third-party effectiveness is achieved by registration).

85. Still other States provide that the secured creditor may enforce its security right in the original encumbered asset and in the proceeds of its disposition up to the value of the outstanding obligation, even when the amount obtained is greater than the value of the original encumbered assets at the time of disposition. The rationale for this result is that providing for a right in proceeds limited only by the value of the outstanding obligations merely reflects what would be the normal intention of the parties. That is, once an automatic right in proceeds is provided, the assumption is that the proceeds of disposition are not simply replacement assets for the value of the original encumbered asset when it was disposed of by the grantor, but are in some sense additional encumbered assets. Unless the parties stipulate otherwise in the security agreement, therefore, the secured creditor should be able to enforce its security right on both the original encumbered assets and the proceeds for an amount limited only by the amount of the obligation outstanding at the time of enforcement. The *Guide* does not introduce any limitation to the security right in proceeds other than that set by the amount of the secured obligation.

9. *Commingled proceeds*

86. When assets that constitute proceeds of encumbered assets are not kept separately from other assets of the grantor, the question arises as to whether the security right in the proceeds is preserved. The answer to this question usually depends on whether the assets constituting the proceeds are identifiable. Proceeds in the form of tangible assets kept with other assets of the grantor can be identified as proceeds in any manner that is sufficient to establish that the tangible assets are proceeds. In this respect, many States provide that the same principle that governs the preservation of the secured creditor's right in original encumbered assets that have been commingled into a mass or product should also apply to tangible assets that constitute commingled proceeds.

87. Two examples will illustrate the point. First, consider the case of a grantor that receives a shipment of construction lumber as proceeds from the sale of manufactured furniture. This lumber is then commingled with other lumber and materials to make finished furniture (a manufactured product). Next, consider the case where a grantor receives a certain amount of gasoline as a swap for crude oil that has been sold and the gasoline is commingled in a tank with other gasoline owned by the grantor. In both cases, the security right should continue into the commingled proceeds, that is, the secured creditor should be able to claim a security right in a proportion of the value of the furniture or a security right in a proportion of the gasoline in the tank. As long as the secured creditor can prove that that amount of lumber or gasoline was received as proceeds, no additional steps should be required in order to create (or preserve) the security right in these commingled tangible proceeds (see the discussion in paras. 90-92 below).

88. If, by contrast, the assets constituting proceeds are intangible, such as receivables or a right to payment of funds credited to a bank account and are not maintained separately from the grantor's other assets of the same type, such intangible assets may be identified as proceeds as long as they can be traced to the original encumbered assets. For example, as long as the secured creditor can prove that a certain amount of cash has been deposited as proceeds of the disposition of encumbered assets, then a claim in the proceeds could arise. The difficulty is that money is constantly entering and exiting bank accounts and it is difficult to know what percentage of the money in a bank account at any given time actually originated as proceeds.

89. Many States have quite complicated rules developed within banking practice to determine when funds deposited in a bank account can be traced. Examples of different tracing rules include the following: (a) "first-in, first-out", which assumes that the first funds to become part of a commingled mass are the first funds withdrawn from the mass; (b) "last-in, first-out", which assumes that the last funds to become part of a commingled mass are the first funds withdrawn from the mass; and (c) the "lowest intermediate balance rule", which assumes, to the extent possible, that withdrawals from the commingled mass are not proceeds of the encumbered assets. Many States protect the security right by providing that the identifiable proceeds will consist of all funds deposited as proceeds, as long as the balance of the account is greater than the amount deposited as proceeds. Under the lowest intermediate balance rule, where the total amount remaining in the account is less than the total amount of proceeds deposited to the account, the identifiable proceeds are determined by taking the lowest intermediate balance (that is, the lowest balance in the fund since the proceeds were initially deposited) and adding to it any further money in the form of proceeds added to the fund since that lowest balance was recorded. As with the case of commingled tangible proceeds, as long as the source of the intangible proceeds can be traced, the *Guide* takes the position that no further steps need to be taken by the parties in order to create (or preserve) the security right in these commingled intangible proceeds (see recommendation 20).

10. *Tangible assets commingled in a mass*

90. Historically, secured transactions regimes did not face the problem of maintaining identification of encumbered assets. As security rights could be taken only in individually identified assets, it was rare that commingling of fungible assets could arise. Today,

however, in many legal systems parties are permitted to create a security right in a general category of (usually fungible) assets. For example, the security right could be created in assets described as “all present inventory of jeans”; alternatively, a seller could take a security right in all the jeans that it sells to a particular purchaser. In both of these cases, it may be that assets subject to the security right are commingled in a manner that prevents separate identification with other assets of the same type that are not subject to the security right.

91. There are two possible approaches to determining the impact that a commingling of tangible assets into a mass has on security rights in the assets created prior to commingling. Some legal systems provide that, once an asset is commingled, it is no longer identifiable and the creditor’s security right is lost. This approach places the burden on the secured creditor the burden to prevent commingling by ensuring that the grantor keeps the encumbered assets separated from other assets of a similar nature. Other legal systems provide that the security right survives and may be claimed in the commingled assets in the same proportion as the encumbered asset bears to the total amount of the commingled assets. Under this approach, if a secured creditor has a security right in €100,000 worth of oil that is commingled with €50,000 worth of oil in the same tank, the security right is deemed to encumber two thirds of whatever oil remains in the tank at the time it becomes necessary to enforce the security right.

92. As the *Guide* adopts the general principle that security rights should be protected as much as possible, it recommends that the second approach be adopted. This means that the security right in the commingled assets is preserved in the same proportion as the encumbered assets and the assets not encumbered by the security right contributed to the mass. In other words, once a security right is created in the encumbered assets, no further steps are necessary to preserve that security right, if the encumbered assets are ultimately commingled with similar assets of the same type that are not subject to the security right (see recommendation 22).

11. *Tangible assets commingled in a product*

93. Tangible assets are often manufactured into a product. When a single asset is so manufactured, the question arises as to whether a security right in raw materials may be traced into the finished product. This question of “products of manufacture” has been dealt with above in the discussion of proceeds. However, manufacturing often involves the combination of several assets in a new product. Hence, whenever tangible assets are so mixed or combined with other tangible assets that their separate identity is lost in a product, it is necessary to determine the conditions under which a security right in the original asset may be claimed in the resulting product. For example, it may be that a security right is taken in flour that is destined to become bread.

94. As in the case of tangible assets commingled in a mass, two basic approaches are taken in various legal systems. In some legal systems, once the commingled asset (that is, the flour) loses its identity as flour, the security right is extinguished. If the parties wish the security right to pass into the product (that is, the bread), it is necessary for them to provide in their security agreement that the original security right encumbers both flour and any product into which the flour may be transformed. Other legal systems take the

position that the security right automatically passes into the manufactured product as long as it can be established that the product resulted from the raw materials subject to the security right. Nonetheless, in order to prevent the secured creditor from obtaining a wind-fall when the resulting product has a value that exceeds the value of the contributed raw materials, in these legal systems the maximum value that may be claimed under the security right is usually limited to the value of the original encumbered asset immediately before it became part of the product.

95. As it is the normal expectation of the parties that raw materials will be manufactured, the *Guide* takes the position that it should not be necessary to provide in the security agreement that the security right passes into the manufactured product. The resulting product is in some sense the replacement or substitute for the security right in the raw materials that no longer exist (see recommendation 22).

12. *Creation or continuation of a security right in an attachment*

96. A movable asset may be attached to another movable asset or to immovable property in such a way that its identity is not lost and it becomes an attachment. In these cases, it is necessary to determine the effect of the characterization of an asset as an attachment on: (a) the ability of a grantor to create a security right in the attachment; and (b) whether a security right to which the original movable asset was subject before attachment is preserved.

97. In some legal systems, it is not possible to create a security right in an attachment that has already become attached to a movable asset or immovable property. In order to be effective, the security right has to be created prior to attachment. In these legal systems, a security right in a movable asset may continue if it becomes an attachment to a movable asset or to immovable property, regardless of the cost or difficulty of removing the attachment from the movable asset or immovable property to which it is attached and regardless of whether the attachment has become an integral part of that movable asset or immovable property. That is, even though the attachment may constitute a significant part of the movable asset in the one case, or is deemed to be immovable property for as long as it remains attached to the immovable property in the other case, these legal systems preserve the security right following the attachment.

98. In other legal systems, it is not only the case that a security right may continue into a movable asset or immovable property following attachment, it is also possible to create a security right in an asset that is already an attachment, whether the attachment is to another movable asset or to immovable property. For these legal systems, the cost or difficulty of detachment is also irrelevant to determining if the security right may be created. In both cases, whether the attachment may be readily removed without damage from the movable asset or immovable property to which it is attached is relevant for determining the priority among competing claimants, but is not relevant to the question of whether the security right may be created. In addition, in these legal systems it is typically possible for a grantor either to create an encumbrance on an attachment to immovable property under the law governing encumbrances on immovable property or to create a security right in such an attachment under the law governing security rights in movable assets.

99. Given its objective of facilitating the creation of security rights, the *Guide* recommends the second of the above-mentioned approaches. Security rights created prior to attachment may be continued following attachment and security rights may be created in attachments even after the attachment has occurred. The key issue is to determine whether any additional steps must be taken for a security right to be continued following attachment or for a security right to be created in an asset that is already an attachment beyond those necessary to create an ordinary security right. Because the *Guide* distinguishes between creation (effectiveness between the parties), third-party effectiveness and priority, it takes the position that no additional steps should be required to continue or to create a security right in an attachment to either movable assets or immovable property (see recommendation 21; for questions of priority, see chapter V, paras. 110-116).

13. Creation or continuation of a security right in a mass or product

100. As noted above, a tangible asset may be commingled with one or more other tangible assets in such a way that its identity is lost. In this case, the question is whether a security right to which the original tangible asset was subject before commingling is preserved. The general position of most legal systems is that the security right is preserved in the mass or product following commingling, assuming that at least some of the commingled assets can be identified as being original encumbered assets. The security right in the originally separate assets is converted into a security right in the product or mass.

101. However, and in contrast to the general approach taken to the creation of security rights in attachments, in most legal systems a security right may not be created in tangible assets after they have been commingled into a mass or product. That is, while an attachment can always be seen to have at least a notional separate identity, this is not the case with commingled assets. Where oil is commingled in a tank or flour is baked into bread, the separate identity of the original encumbered asset disappears. For this reason, it is generally not possible to create a separate security right in tangible assets that have already been commingled in a mass or product.

102. The *Guide* follows the approach adopted in most legal systems. It does not contemplate that separate security rights may be created in tangible assets that have already been commingled in a mass or product. Once again, however, the central question is whether it is necessary to take additional steps to preserve the effectiveness of a security right between the parties when original encumbered assets later become commingled in a mass or product. For the same policy reasons that favour the continuation of a security right into an attachment without the need for an additional step, the *Guide* recommends that no additional steps should be required in the case of commingling (see recommendation 22).

B. Asset-specific remarks

1. Effectiveness of a bulk assignment of receivables and an assignment of a future receivable or a part of or an undivided interest in a receivable

103. The receivables of a business are widely used as an asset to secure the performance of an obligation. The creation of a security right in receivables is commonly called an

assignment, although in some States a distinction continues to be drawn between a pledge of receivables on the one hand and their assignment on the other. In view of the identical nature of an assignee's and pledgee's ability to collect payment of a receivable, a trend is developing to subject the assignment to the same rules whether it involves an outright transfer of a receivable, a transfer of a receivable for security purposes or a security right in a receivable. These similar rules govern the creation of the security right, third-party effectiveness and priority, although the enforcement of an outright transfer remains to some extent subject to different provisions. This trend is mainly justified both by the fact that it is often quite difficult for third parties to determine the nature of an assignment and by the need to have the same third-party effectiveness and priority rules govern all types of financing transaction involving the assignment of receivables. This trend is reflected in the United Nations Assignment Convention (see article 2) and is the position recommended in the *Guide* (see recommendation 3).

104. Legal systems do differ, however, as to the precise requirements for making an assignment effective. Some legal systems require a writing evidencing the assignment or actual notification of the debtor of the receivable. Other legal systems only require written form for the assignment to be effective as between the assignor and the assignee. Other formalities, such as registration or notification of the debtor of the receivable, are required only in order to make the assignment effective as against third parties or to enable the assignee to collect the receivable. The *Guide* takes the position that a receivable is like any other asset and that, consequently, the specific formalities for creating a security right in a receivable should be no different than those applicable to tangible assets.

105. Legal systems also differ with respect to the effectiveness of assignments of future receivables and receivables not specifically identified and with respect to the effectiveness of assignments of parts of or an undivided interest in receivables. Nonetheless, the modern trend is to validate all these types of assignment, provided that the receivables (or parts or interests) can be identified as covered by the assignment and to provide that the assignment of future receivables is effective without the need for a new assignment for each future receivable (see article 8 of the United Nations Assignment Convention). The rationale for this result is that as long as the assignor and assignee are in agreement as to the scope of the receivables assigned, no further formality need be imposed in order for the assignment to be effective between the assignor and the assignee. Consistent with the United Nations Assignment Convention, this is the approach recommended in the *Guide* (see recommendation 23).

2. *Effectiveness of an assignment of receivables made despite an anti-assignment clause*

106. In some legal systems, effect is given to contractual restrictions on assignments of receivables in order to protect the interest of the party in whose favour the restriction is stipulated (that is, the assignor or the debtor of the receivable). In other legal systems, no effect is given to contractual restrictions on assignments of receivables in order to preserve the assignor's (or grantor's) freedom of disposition and the rights of the assignee (or secured creditor), in particular if the assignee is not aware of the contractual restriction. In yet other legal systems, only a limited effect is given to contractual restrictions on assignments of receivables (as between the parties to the agreement).

107. The United Nations Assignment Convention takes the latter approach in order to support the assignability of receivables. The rationale for this approach is that it promotes receivables financing, which in turn is likely to increase the assignor's ability to extend credit to the debtor of the receivable. If specific debtors of receivables require protection in particular cases (for example, certain types of consumer debtors) or if reasons of public policy militate against assignability (for example, limitations on the assignment of wages, pensions or welfare benefits) these limitations should be established in other law (and they are not offered by the law recommended in the *Guide*; see recommendation 18).

108. Under article 9, paragraph 1, of the United Nations Assignment Convention, an assignment is effective despite a contractual restriction on assignment agreed upon between the assignor ("grantor" in the terminology of the *Guide*) and the debtor ("debtor of the receivable" in the terminology of the *Guide*). However, the effect of this provision is limited in two ways. First, its application is limited to broadly defined trade receivables (see article 9, paragraph 3, of the Convention). It does not apply to so-called "financial receivables" because, where the debtor of the receivable is a financial institution, even partial invalidation of an anti-assignment clause could affect obligations undertaken by the financial institution towards third parties. Such a result is likely to have negative effects on important financing practices, such as those involving the assignment of receivables arising from or under securities or financial contracts (which are excluded from the scope of the *Guide*; see recommendation 4, subparagraphs (c)-(e)).

109. The second limitation on the rule set out in article 9, paragraph 2, of the United Nations Assignment Convention is that, if such a contractual restriction is valid under law applicable outside the Convention, it is not invalidated as between the assignor and the debtor of the receivable. The debtor is free to claim damages from the assignor for breach of contract, if such a claim exists under law applicable outside the Convention, but may not raise this claim against the assignee by way of set-off (see article 18, paragraph 3). In addition, mere knowledge of the existence of the restriction on the part of the assignee ("secured creditor" in the terminology of the *Guide*) is not enough for the avoidance of the contract from which the assigned receivable arises (see article 9, paragraph 2).

110. This approach promotes receivables financing transactions since it relieves the assignee of the potentially costly and time-consuming burden of having to examine each of the contracts from which the assigned receivables arose in order to ascertain whether the assignment of the receivables has been prohibited or made subject to conditions. The *Guide* recommends the same approach to these matters as is found in the United Nations Assignment Convention (see recommendation 24).

3. *Creation of a security right in a personal or property right securing a receivable, a negotiable instrument or any other intangible asset*

111. If a grantor creates a security right in a receivable, negotiable instrument or any other intangible asset in favour of a secured creditor, the issue arises as to whether the secured creditor also has, automatically and without any further action by the grantor or the secured creditor, the benefit of any personal right (such as a guarantee or suretyship) or property right (such as a security right in other movable property or a mortgage on immovable property) that secures payment of the receivable, negotiable instrument or other intangible asset.

112. In most legal systems, the creation of the security right in the receivable, negotiable instrument or other intangible asset will also automatically give the secured creditor the full benefit of the grantor's full set of rights with respect to that receivable, negotiable instrument or intangible asset. Thus, if the obligation to pay the receivable, negotiable instrument or other intangible asset is itself secured by a security right in an asset of the obligor, the secured creditor should also receive the benefit of the grantor's rights with respect to the security right in the obligor's asset (see recommendation 25, subparagraph (a)).

113. The rule described in the preceding paragraph applies regardless of whether the grantor is limited by any agreement with the debtor of the receivable or the obligor of the negotiable instrument or other intangible asset from creating a security right in the receivable, negotiable instrument or other intangible asset or in the personal or property right securing payment or other performance of the receivable, negotiable instrument or other intangible asset (see recommendation 25, subparagraph (d)). However, nothing contained in such a provision affects the grantor's liability for breaching the agreement, except that the other party to the agreement may not avoid the agreement giving rise to the receivable, negotiable instrument or other intangible asset or the personal or property right securing the same upon the sole ground of that breach (see recommendation 25, subparagraph (e)).

114. However, because the secured creditor's rights with respect to the personal or property right flow from the grantor's rights, the secured creditor's rights with respect to that personal or property right cannot be greater than the grantor's rights with respect to it.

115. Where the receivable, negotiable instrument or other intangible asset is secured by an independent undertaking, the secured creditor's security right does not extend to the right to draw under the independent undertaking, but rather extends only to the proceeds under the independent undertaking (see recommendation 25, subparagraph (b)). This is consistent with the theme of the *Guide* that a beneficiary of an independent undertaking may not transfer the right to draw without the consent of the guarantor/issuer, confirmer or other nominated person.

116. There are several practical reasons supporting the recommendation that the secured creditor should have a security right in a right to receive the proceeds under an independent undertaking. First, this result merely eliminates the need for the secured creditor to take certain additional steps in its loan documentation with the grantor. That is, because, even if the *Guide* were to make the distinction between an accessory right and an independent right (a distinction that is made under the laws of a number of States), that distinction would not prevent the secured creditor from obtaining a security right in a right to receive the proceeds under an independent undertaking. It would merely require the secured creditor to take the formalistic steps of including an express creation of a security right in a right to receive the proceeds under an independent undertaking in its security agreement with the grantor. Eliminating the need for such formalism furthers the *Guide's* goal of reducing the costs of credit and making more credit available by reducing transaction costs.

117. Second, the automatic creation rule for a security right in a right to receive the proceeds under an independent undertaking would make sense in practice as being

consistent with the parties' normal expectations. A secured creditor looking to the grantor's receivables as encumbered assets would normally expect that, regardless of how the receivables owed were paid (for example, whether directly by the debtors of the receivables or by a draw under an independent undertaking securing one or more of the receivables), the secured creditor would have a security right in the payment as proceeds of the receivables. Indeed, in some cases a secured creditor may be willing to extend credit to a given borrower at a lower rate if the secured creditor knows that its security right in the receivables owed to the borrower includes a security right in the right to receive the proceeds under an independent undertaking. A rule that is consistent with the parties' normal expectations will avoid unfair surprise and create greater certainty in States that enact the recommendations of the *Guide*. Greater certainty will make credit providers more confident in extending credit and accordingly will further the goal of the *Guide* to encourage greater availability of secured credit (see recommendation 1, subparagraph (a)).

118. Third, the recommendation does not affect in any way the rights of the guarantor/issuer, confirmer or nominated person under the independent undertaking. Neither the guarantor/issuer nor any confirmer nor any nominated person has any obligation to accept a request for payment from anyone other than the beneficiary of the independent undertaking or has any obligation to pay anyone other than the beneficiary, without the consent of the guarantor/issuer, confirmer or nominated person.

119. The *Guide* qualifies the foregoing recommendation in a number of important respects. First, it does not affect a right in immovable property that, under law other than the secured transactions law, is transferable separately from the receivable, negotiable instrument or other intangible asset that it secures. This recommendation addresses a device that may exist in some States that permits an owner of immovable property to create a right (mortgage) in the immovable property even though at the time of creation the right does not secure any obligation. The owner may then transfer that right to a creditor, who may in turn transfer the right to another creditor. Like an independent undertaking, the right in the immovable property appears to be a right in itself independent of any obligation.

120. The second qualification is that, consistent with the United Nations Assignment Convention, the recommendation applies only to certain types of receivable, negotiable instrument or other intangible asset (see recommendation 25, subparagraph (f)), such as trade receivables (for example, receivables evidencing the sale of goods and the provision of services).

121. The third qualification is that the recommendation does not affect any obligations of the grantor to the debtor of the receivables or the obligor on the negotiable instrument or other intangible asset (see recommendation 25, subparagraph (g)).

122. Finally, the recommendation does not affect any requirement under law other than the secured transactions law relating to the form or registration of the creation of a security right on any asset that secures payment or performance of a receivable, negotiable instrument or other intangible asset, but only to the extent that the automatic creation of the benefit of such security right is not impaired (see recommendation 25, subparagraph (h)).

4. *Creation of a security right in a right to payment of funds credited to a bank account*

123. Funds credited to a bank account are a particular form of receivable payable to the holder of the account. The bank is the debtor of the receivable, the value of which fluctuates according to the amount credited to the account. The receivable is commonly described as a right to receive payment of the funds credited to the account. Subject to any limitations on withdrawals that may be stipulated in the agreement under which the account was opened, the funds credited to the account must be paid to the account holder on demand. In most account agreements, it is provided that the holder of the account may not assign the right to receive payment or create a security right in that payment right. In their objectives and form, these limitations closely resemble contractual restrictions on the assignment of receivables.

124. As noted above (see paras. 106-110), in some legal systems full effect is given to such contractual restrictions. In other legal systems, these restrictions are given either no effect or only a limited effect. The position recommended in the *Guide* is that an assignment of a receivable is effective between the assignor and the assignee notwithstanding an agreement limiting the assignor's right to assign the receivable (see recommendation 24, subparagraph (a)). For the same policy reasons, the approach of the *Guide* is that a properly constituted security right in a right to payment of funds credited to a bank account is effective notwithstanding any agreement that purports to limit the account holder's right to create a security right (see recommendation 26).

125. Even though the security right may be effective between the account holder and the secured creditor, this does not mean, however, that the secured creditor automatically acquires any rights that may be set up against the bank. The special nature of banking transactions requires a rule that generally protects banks from being obliged to make payment of funds to any person other than the account holder, or to perform any other obligation (such as providing information about the account) that may arise under the security agreement. Only where the bank explicitly consents to the security agreement will it be liable to pay the funds credited to the account to the secured creditor. In keeping with its general policy of deferring to specialized practices in the financial and banking sectors, the *Guide* also recommends this approach in relation to the obligations of the bank to a secured creditor (see recommendation 26).

5. *Creation of a security right in a right to receive the proceeds under an independent undertaking*

126. The domain of letters of credit and independent undertakings is, like the field of banking, a highly specialized part of modern commercial law with well-established rules and practices. A large part of this law and practice is either transnational or common to most States. For example, it is a generally accepted principle governing independent undertakings that the right to request payment ("draw") under the undertaking may not be transferred without the consent of the guarantor/issuer, confirmer or nominated person under the independent undertaking (see for example, the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit,¹ the Uniform

¹United Nations publication, Sales No. E.97.V.12.

Customs and Practice for Documentary Credits, the Rules on International Standby Practices and the Uniform Rules for Demand Guarantees). In view of the widespread acceptance of this principle, the *Guide* recommends it (see recommendation 27).

127. However, the *Guide* also draws a distinction between the right to draw under an independent undertaking and the right to receive the proceeds of a draw under an independent undertaking. As in the case of restrictions on assignability of receivables and a right to payment of funds credited to a bank account, the *Guide* contemplates that the beneficiary of an independent undertaking may create a security right in relation to its rights. Even if the right to draw under the undertaking is itself not transferable under applicable law and practice, or even if any purported transfer of the right to draw cannot be set up against the issuer, the *Guide* takes the view that nothing in the law or practice governing independent undertakings prevents the beneficiary of an independent undertaking from creating a security right in its right to receive the proceeds of the undertaking once payment is made. Consequently it provides a recommendation to that effect (see recommendation 27).

6. *Creation of a security right in a negotiable document or a tangible asset covered by a negotiable document*

128. When a negotiable document, such as a bill of lading or a warehouse receipt, has been issued with respect to tangible assets and is outstanding, the document embodies the title to the identified tangible assets. As a result, title to the identified assets may pass by means of a transfer of the negotiable document. From this principle that the document embodies the asset, it follows that the creation of a security right in the negotiable document also operates as the creation of a security right in the tangible assets themselves, provided that the security right in the document is created while the assets are covered by the document (see recommendation 28). For this purpose, the assets are covered by the document if they are in the possession of the issuer of the document or an agent acting on behalf of the issuer of the document at the time the security right is created. Other than the requirement of possession by the issuer, there are no other prerequisites for creating a security right in a negotiable document that is effective between the parties beyond those discussed above (see paras. 12-33 above).

C. Recommendations 13-28

Purpose

The purpose of provisions on the creation of a security right is to specify the requirements that must be satisfied in order for a security right to be effective between the parties.

1. General recommendations*

Creation of a security right

13. The law should provide that a security right in an asset is created by an agreement concluded between the grantor and the secured creditor. In the case of an asset with respect to which

*The general recommendations apply to security rights in all types of asset covered in the *Guide*, as modified by the asset-specific recommendations.

the grantor has rights or the power to encumber at the time of the conclusion of the agreement, the security right in that asset is created at that time. In the case of an asset with respect to which the grantor acquires rights or the power to encumber thereafter, the security right in that asset is created when the grantor acquires rights in the asset or the power to encumber the asset.

Minimum content of a security agreement

14. The law should provide that a security agreement must:
- (a) Reflect the intent of the parties to create a security right;
 - (b) Identify the secured creditor and the grantor;
 - (c) Describe the secured obligation;
 - (d) Describe the encumbered assets in a manner that reasonably allows their identification;
- and
- (e) Indicate the maximum monetary amount for which the security right may be enforced, if the State determines that such an indication would be helpful to facilitate subordinate lending.

Form of the security agreement

15. The law should provide that a security agreement may be oral if accompanied by the secured creditor's possession of the encumbered asset. Otherwise, the agreement must be concluded in or evidenced by a writing that, by itself or in conjunction with the course of conduct between the parties, indicates the grantor's intent to create a security right.

Obligations secured by a security right

16. The law should provide that a security right may secure any type of obligation, whether present or future, determined or determinable, conditional or unconditional, fixed or fluctuating.

Assets subject to a security right

17. The law should provide that a security right may encumber any type of asset, including parts of assets and undivided rights in assets. A security right may encumber assets that, at the time the security agreement is concluded, may not yet exist or that the grantor may not yet own or have the power to encumber. It may also encumber all assets of a grantor. Any exceptions to these rules should be limited and described in the law in a clear and specific way.

18. The law should provide that, except as provided in recommendations 23-25, it does not override provisions of any other law to the extent that they limit the creation or enforcement of a security right in, or the transferability of, specific types of asset.

Continuation of a security right in proceeds

19. The law should provide that, unless otherwise agreed by the parties to a security agreement, a security right in an encumbered asset extends to its identifiable proceeds (including proceeds of proceeds).

Commingled proceeds

20. The law should provide that, where proceeds in the form of money or funds credited to a bank account have been commingled with other assets of the same kind so that the proceeds are

no longer identifiable, the amount of the proceeds immediately before they were commingled is to be treated as identifiable proceeds after commingling. However, if, at any time after commingling, the total amount of the asset is less than the amount of the proceeds, the total amount of the asset at the time that its amount is lowest plus the amount of any proceeds later commingled with the asset is to be treated as identifiable proceeds.

Creation and continuation of a security right in an attachment

21. The law should provide that a security right may be created in a tangible asset that is an attachment at the time of creation of the security right or continues in a tangible asset that becomes an attachment subsequently. A security right in an attachment to immovable property may be created under this law or under the law governing immovable property.

Continuation of a security right into a mass or product

22. The law should provide that a security right created in tangible assets before they are commingled in a mass or product continues in the mass or product. The amount secured by a security right that continues in the mass or product is limited to the value of the encumbered assets immediately before they became part of the mass or product.

2. Asset-specific recommendations

Effectiveness of a bulk assignment of receivables and an assignment of a future receivable or a part of or an undivided interest in a receivable

23. The law should provide that:

(a) An assignment of contractual receivables that are not specifically identified, a future receivable or a part of or an undivided interest in a receivable is effective as between the assignor and the assignee and as against the debtor of the receivable as long as, at the time of the assignment or, in the case of a future receivable, at the time it arises, it can be identified to the assignment to which it relates; and

(b) Unless otherwise agreed, an assignment of one or more future receivables is effective without a new act of transfer being required to assign each receivable.²

Effectiveness of an assignment of a receivable made despite an anti-assignment clause

24. The law should provide that:

(a) An assignment of a receivable is effective as between the assignor and the assignee and as against the debtor of the receivable notwithstanding an agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting in any way the assignor's right to assign its receivables;

(b) Nothing in this recommendation affects any obligation or liability of the assignor for breach of the agreement mentioned in subparagraph (a) of this recommendation, but the other party to such an agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(c) This recommendation applies only to assignments of receivables:

(i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;

²For recommendations 23-25, see articles 8-10 of the United Nations Assignment Convention.

- (ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;
- (iii) Representing the payment obligation for a credit card transaction; or
- (iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

Creation of a security right in a personal or property right that secures a receivable, a negotiable instrument or any other intangible asset

25. The law should provide that:

(a) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right that secures payment or other performance of the receivable, negotiable instrument or intangible asset automatically, without further action by either the grantor or the secured creditor;

(b) If the personal or property right is an independent undertaking, the security right automatically extends to the right to receive the proceeds under the independent undertaking but does not extend to the right to draw under the independent undertaking;

(c) This recommendation does not affect a right in immovable property that under other law is transferable separately from a receivable, negotiable instrument or other intangible asset that it may secure;

(d) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right that secures payment or other performance of the receivable, negotiable instrument or other intangible asset notwithstanding any agreement between the grantor and the debtor of the receivable or the obligor of the negotiable instrument or other intangible asset limiting in any way the grantor's right to create a security right in the receivable, negotiable instrument or other intangible asset, or in any personal or property right securing payment or other performance of the receivable, negotiable instrument or other intangible asset;

(e) Nothing in this recommendation affects any obligation or liability of the grantor for breach of the agreement mentioned in subparagraph (d) of this recommendation, but the other party to such an agreement may not avoid the contract from which the receivable, negotiable instrument or other intangible asset arises, or the security agreement creating the personal or property security right on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(f) Subparagraphs (d) and (e) of this recommendation apply only to security rights in receivables, negotiable instruments or other intangible assets:

- (i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;
- (ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;
- (iii) Representing the payment obligation for a credit card transaction; or
- (iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties;

(g) Subparagraph (a) of this recommendation does not affect any duties of the grantor to the debtor of the receivable or to the obligor of the negotiable instrument or other intangible asset; and

(h) To the extent that the automatic effects under subparagraph (a) of this recommendation and recommendation 48 are not impaired, this recommendation does not affect any requirement under other law relating to the form or registration of the creation of a security right in any asset, securing payment or other performance of a receivable, negotiable instrument or other intangible asset that is not covered by this law.

Creation of a security right in a right to payment of funds credited to a bank account

26. The law should provide that a security right in a right to payment of funds credited to a bank account is effective notwithstanding an agreement between the grantor and the depository bank limiting in any way the grantor's right to create such a security right. However, the depository bank has no duty to recognize the secured creditor and no obligation is otherwise imposed on the depository bank with respect to the security right without the depository bank's consent.³

Creation of a security right in a right to receive the proceeds under an independent undertaking

27. The law should provide that a beneficiary of an independent undertaking may create a security right in a right to receive the proceeds under an independent undertaking, even if the right to draw under the independent undertaking is itself not transferable under the law and practice governing independent undertakings. The creation of a security right in a right to receive the proceeds under an independent undertaking is not a transfer of the right to draw under an independent undertaking.

Extension of a security right in a negotiable document to the tangible asset covered by the negotiable document

28. The law should provide that a security right in a negotiable document extends to the tangible asset covered by the document, provided that the issuer is in possession of the asset, directly or indirectly, at the time the security right in the document is created.

³For the depository bank's rights and obligations, see recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors).

III. Effectiveness of a security right against third parties

A. General remarks

1. Introduction

1. Chapter II of the *Guide* addresses the requirements for creation of a security right, that is, its effectiveness as between the secured creditor and grantor. In some States a security right in movable assets takes effect both between the parties and against third parties as soon as the security agreement is entered into without the need for the secured creditor (or any other person) to take an additional step. However, other States require an additional step be taken in order for the security right to become effective against third parties. This additional step is designed to provide some form of public notice of the actual or potential existence of a security right in an asset. Examples of such a step include a transfer of possession of the encumbered assets to the secured creditor (as under a traditional possessory pledge) or the registration of a notice in a public registry. Publicity requirements of this kind contribute to the efficiency, certainty and predictability of a regime of secured transactions in several ways. First, they provide potential secured creditors with objective evidence that the grantor's assets may already be encumbered. Second, as they alert the grantor's creditors, prospective buyers and other third parties to the potential existence of a security right, there is no need for special rules protecting third parties against the risk posed by hidden ("secret") security rights in the grantor's assets. Third, they establish a defined temporal event that can easily be used to determine the order of priority between a secured creditor and a competing claimant.

2. Section A.2 of this chapter discusses some basic policy issues relating to the distinction between creation and third-party effectiveness. It also addresses the key conceptual distinction between third-party effectiveness and priority. Sections A.3 to A.5 of the chapter discuss in detail the three principal methods for achieving third-party effectiveness (that is, registration of a notice of a security right in a general security rights registry, possession and registration in a specialized asset-specific registry). Sections A.6 to A.8 consider cases where a security right that has been made effective against third parties continues to be effective in assets not initially subject to the security right (proceeds, attachments and masses or products). Sections A.9 and A.10 address other issues of continuity, notably where the asset or the grantor changes location or where third-party effectiveness lapses.

3. Part B of this chapter is devoted to a discussion of various methods for achieving third-party effectiveness that apply to specific types of asset. Section B.1 considers the important cases where a secured creditor acquires the benefit of associated rights securing the payment of a receivable, negotiable instrument or other intangible asset. Section B.2 reviews third-party effectiveness of a security right in a right to payment of funds credited to a bank account. Section B.3 assesses how third-party effectiveness may be achieved where the security right encumbers the right to receive proceeds under an independent

undertaking. Finally, section B.4 addresses third-party effectiveness of a security right in a negotiable document or in assets covered by a negotiable document.

4. The chapter concludes, in section C, with a series of recommendations about methods for achieving third-party effectiveness and the legal consequences of the application of these methods.

2. Basic policy issues

5. States confront several basic policy choices when enacting a regime to govern third-party effectiveness of a security right, including the following. First, they must decide whether a security right that is effective between the parties is also automatically effective against third parties, or whether an additional act will be required to make a security right effective against third parties. Second, assuming an additional act is thought to be necessary they must determine which other persons (for example, secured and unsecured creditors, subsequent acquirers and insolvency representatives) will be considered third parties for the purposes of the rules relating to third-party effectiveness. Third, States must determine the relationship between achieving third-party effectiveness of a security right and determining the priority that will be given to that particular security right. Fourth, States must determine what types of additional act should be sufficient to make a security right effective against third parties. These policy issues are addressed in turn in this section.

(a) Distinction between creation and third-party effectiveness

6. Among States that require an additional act to publicize a security right, some treat it not only as a prerequisite to achieving third-party effectiveness but also as a prerequisite to the very creation of the security right. The idea here is that, because a central goal of taking security is to obtain a property right enforceable against the grantor and third parties, there is no utility in distinguishing between effectiveness between the parties and effectiveness against third parties. In other States, the additional act is required only for the purpose of making the security right effective against third parties. As between the parties, the security right is immediately effective at the time when they enter into the security agreement and, in the case of future assets, at the time when the grantor acquires rights in the encumbered asset or the power to encumber it. The idea here is that, because the requirement for taking an additional step is aimed solely at balancing the rights of the secured creditor and third parties, there is no reason why it should be a precondition for the secured creditor's ability to enforce its security right in the encumbered asset as against the grantor (for a third, hybrid, regime, see chapter II on the creation of a security right, para. 4 and para. 8 below).

7. In line with the approach taken in most States that have modernized their secured transactions laws and in order to promote efficient secured credit, the *Guide* recommends the second approach. Consequently, once the conditions for creation of a security right (which are addressed in chapter II) are satisfied, the security right becomes effective as between the grantor and the secured creditor (that is, *inter partes*; see recommendation 30). However, in order for the security right to affect the rights of third parties (*erga omnes*), the requirements for third-party effectiveness set out in this chapter must also be satisfied (see recommendation 29).

8. In States that do not recognize a distinction between the *inter partes* and the *erga omnes* effects of property rights in their general property laws, adoption of this approach may generate some conceptual concerns. However, not drawing the distinction can undermine the efficiency of the secured transactions regime. On the one hand, if the additional act necessary to achieve third-party effectiveness is also required to create a security right, this would result in an additional formality to the creation of a security right without any compensating advantage for grantors, secured creditors and third parties. On the other hand, if no additional formality is required, this approach would result in the creation of a secret security right (see chapter II on the creation of a security right, paras. 1-3). An alternative might be to treat a security right effective against all parties upon its creation with the exception of other secured creditors. This alternative generally leads to the same results as the second of the two approaches just mentioned with some variations as to the rights of judgement creditors and the grantor's insolvency representative (see chapter II on the creation of a security right, para. 4 and paras. 9-14 below).

(b) *Meaning of "third parties"*

9. States take quite different approaches to the categories of third parties against which a security right is ineffective unless the required additional step is taken. In some States, a security right has no effect against third parties, whatever their status, until the additional step is taken. Other States adopt a more qualified approach, treating a security right as fully effective upon creation as against certain categories of third parties (see chapter II on the creation of a security right, paras. 3-4).

10. In some States, a security right is effective upon creation not only as between the grantor and the secured creditor, but also as against the grantor's unsecured creditors and insolvency representative (such references to an insolvency representative refer to an insolvency representative appointed at a future time should the grantor become insolvent). This approach is based on the assumption that notice of a security right should matter only to those third parties that take a security right, purchase an encumbered asset or otherwise give value in direct reliance on the grantor's apparently unencumbered title to the asset. The grantor's unsecured creditors and their representatives (such as an insolvency representative) are presumed not to rely on the presence or absence of security rights in the grantor's assets, since the very act of extending credit on an unsecured basis implies acceptance of the risk of subordination to secured creditors that may later acquire security rights in the grantor's assets.

11. There are, nonetheless, several reasons why the additional step necessary for third-party effectiveness should be required even as against a grantor's unsecured creditors and insolvency representative. First, while unsecured creditors base their decision to lend on the grantor's general financial health, the presence or absence of security rights may be one of the factors upon which that assessment is based and may also be considered by credit reporting agencies on whose services unsecured creditors may rely. Second, the requirement for timely public registration or some equivalent additional step reduces the risk that an alleged security right is a collusive arrangement between an insolvent grantor and a preferred creditor to defeat the claims of other unsecured creditors. Third, it enables judgement creditors to determine in advance of initiating costly enforcement action whether the grantor's assets may already be encumbered to an extent that would render the enforcement

action fruitless. Fourth, it reduces the costs of insolvency proceedings by giving the insolvency representative an easy means of ascertaining which assets of the insolvent grantor are potentially encumbered. Together, these reasons provide a significant incentive for secured creditors to make their security rights fully effective in a timely fashion.

12. Other States recognize an exception to the usual requirements for third-party effectiveness. In these States, even if a secured creditor has not taken the steps necessary to make its security right fully effective against third parties, its security right may nevertheless be effective as against a subsequent secured creditor or buyer that acquires rights in an encumbered asset with actual knowledge of the prior creation of a security right. There are reasons why this qualification is not well suited to an efficient secured transactions regime. A key objective of an efficient regime is to provide *a priori* certainty (that is, in advance of the conclusion of a security or purchase agreement) in the ordering of competing rights in encumbered assets. A third-party effectiveness rule that depends on fact-specific *ex post facto* inquiry or litigation is inimical to that goal. Moreover, establishing knowledge on the part of another person and the precise extent of knowledge raises difficult questions of proof. In addition, mere knowledge of the existence of a prior security agreement does not imply bad faith on the part of a subsequent secured creditor or buyer. If the prior secured creditor has not taken the steps necessary to make its security right fully effective against third parties, the subsequent secured creditor or buyer may reasonably assume that the prior secured creditor has implicitly consented to the risk of its rights being ineffective against third parties.

13. Some States also deny protection to a subsequent donee of an encumbered asset on the theory that, as between a secured creditor that, by definition, has given value for its security right and a donee that has not, the secured creditor should be protected notwithstanding its failure to take the steps necessary to achieve third-party effectiveness. For reasons similar to those considered in the preceding paragraph, this qualification is not well suited to an efficient secured transactions regime. Determining the status of a transferee of an encumbered asset invites *ex post facto* litigation contrary to the goals of achieving *a priori* certainty and predictability. Moreover, even if the donee's status is not contested, the donee may well have changed its position in reliance on the unencumbered status of the asset (for example, by creating a security right in favour of another creditor).

14. In the interest of achieving efficiency, transparency and predictability in the secured transactions regime, the *Guide* recommends the first approach described above (see recommendation 29). Until the conditions for third-party effectiveness are satisfied, the security right is ineffective against all intervening rights in the encumbered assets acquired by third parties regardless of their type. If other law in effect in an enacting State does not treat a grantor's unsecured creditors or insolvency representative as a third party, the secured transactions law should make it clear that failure to satisfy the requirements for third-party effectiveness also renders the security right ineffective against these categories of claimants.

(c) *Relationship between third-party effectiveness and priority*

15. Third-party effectiveness rules produce priority consequences in the sense that a security right that has not been made effective against third parties cannot be set up against

rights acquired by third parties in the same encumbered assets. Nonetheless, attaining third-party effectiveness is not always sufficient to ensure absolute priority against competing claimants. As explained more fully in chapter V, priority depends upon the nature and status of the rights with which a security right is competing. For example, if more than one security right has been made effective against third-parties, it will be necessary to have a priority rule to rank the competing security rights as among themselves.

16. As a general rule, the *Guide* recognizes that a secured creditor that has complied with the requirements for third-party effectiveness with respect to its security right in a particular encumbered asset has a “right to follow” the encumbered asset. This means that the security right continues to be effective against a third party to whom the grantor transfers rights in the encumbered asset (see recommendation 31, and para. 89 below; see also chapter II on the creation of a security right, paras. 72-89).

17. However, as explained in chapter V on the priority of a security right, the *Guide* recognizes certain exceptions to the “right to follow” principle. For example, where the transfer of an encumbered asset occurs in the ordinary course of the grantor’s business, a buyer, lessee or licensee of the encumbered asset generally acquire their rights in the encumbered asset free of a security right even when the security right is otherwise effective against third parties (see recommendations 31, 79-81; see also para. 89 below and chapter V on the priority of a security right, paras. 60-89).

18. In sum, even though third-party effectiveness and priority are distinct concepts, it is essential to take account of the priority rules addressed in chapter V in assessing the degree of protection against third parties afforded by complying with the various methods of achieving third-party effectiveness recognized in this chapter. In line with the comprehensive concept of third-party effectiveness recommended in this chapter, the concept of priority in chapter V of the *Guide* is similarly broad. Thus, chapter V addresses not only rules for ranking the competing claims of secured and unsecured creditors in the assets of the grantor, but also considers exceptions to the secured creditor’s “right to follow” in a contest between a secured creditor and a competing transferee, lessee or licensee of an encumbered asset. In this latter situation, the relevant “priority” issue is not one of ranking but whether the transferee acquires title to the encumbered asset, the lessee acquires a right to possession of the leased asset or the licensee acquires a right to use the licensed asset, in each case free of a security right that is otherwise effective against third parties.

(d) Overview of methods for achieving third-party effectiveness

19. Historically, most States imposed a general prohibition on non-possessory security rights in movable assets. This approach left the traditional possessory pledge as the only available security device, with a transfer of possession of the pledged assets to the secured creditor serving both to constitute the pledge and to provide the third parties with implicit notice that the grantor does not hold unencumbered title to the assets in question. As economies developed, however, the limits of the traditional pledge became more obvious. First, a grantor normally needs to remain in possession of its business assets in order to carry on its business. Second, the traditional pledge cannot cover future assets because of the practical impossibility of transferring possession of future assets at the time of the

creation of a pledge. Third, the traditional pledge cannot cover intangible assets as it requires transfer of possession of the pledged assets and intangible assets are not susceptible to possession (see chapter I on the scope of application, paras. 57-58). Consequently, some form of non-possessory security right needed to be developed. States have responded to this demand in various ways (see chapter I on the scope of application, paras. 62-100).

20. Some States allow the parties to use the device of a sale by the grantor of its movable assets to the secured creditor (without a transfer of possession), subject to the grantor's right to redeem title to the assets on payment of the credit represented by the sale price. Under this approach, the sale (security) agreement is sufficient for both creation and third-party effectiveness. While this approach has the apparent advantage of simplicity, it generates significant legal risk. Third parties, including potential secured creditors, have no objective means of verifying whether assets in a person's possession are subject to a security right. In addition, owing to the secret nature of this device, States that adopt this approach usually find it necessary to protect the rights of third parties that deal with assets in the grantor's possession without actual knowledge of the prior transfer of title (security right) in favour of a secured creditor. As these legal risks diminish the certainty and predictability of security rights, they can have a corresponding negative impact on the cost of and access to secured credit.

21. Other States have responded to the practical need for non-possessory secured financing by sanctioning artificial pledges under which mere constructive or symbolic creditor possession is sufficient. For example, under this approach the grantor may declare that it is holding possession of the encumbered assets for the benefit of the secured creditor. This approach gives rise to the same legal risks identified in the preceding paragraph. Still other States have reformed their laws to recognize new forms of non-possessory security rights without at the same time resolving the publicity issue in a comprehensive way. Instead, they attempt to contain the potential prejudice to third-party rights by imposing various costly and time-consuming formal prerequisites designed to limit the scope of these new devices to specific assets. These may include, for example, a requirement that the deed by which security is granted be filed in the office of a notary and only be available for consultation there.

22. Alternatively and sometimes in addition to the above-mentioned approaches, some States adapted the concept of public registration of security rights from the immovable property context as a means for achieving third-party effectiveness of security rights in movable assets. As already noted, the great advantage of a public registry is that it gives potential secured creditors an objective source of information as to whether a person's assets may already be encumbered. Moreover, since a public registry alerts the grantor's other creditors and buyers of the grantor's assets to the potential existence of a security right and any other right that must be registered, there is no need for special rules protecting third parties against the risk posed by secret rights in a person's assets. This feature in turn enhances the certainty and predictability of security rights.

23. While there are different types of registration regime in different States, a frequent approach in States that have adopted a comprehensive reform strategy is to establish a general security rights registry for all movable assets. For reasons discussed in detail in the next section, this is the approach recommended in the *Guide* (see recommendation 32).

24. Even in States that have adopted a general security rights registry, various other methods for achieving third-party effectiveness may also be available, depending on the nature of the encumbered assets. For example, almost all of these States continue to recognize that a security right in tangible assets may be made effective against third parties by a transfer of possession of the assets to the secured creditor. In some of these States, the transfer of possession by itself continues to constitute a distinct security right called a “pledge”, while in others, the parties’ agreement is seen to create the security right and the transfer of possession is understood simply as an alternative method to registration for achieving third-party effectiveness. This latter approach is the approach recommended in the *Guide* (see recommendation 34).

25. Some States have also adopted, as an alternative to possession or public registration, specialized rules relating to the “control” of encumbered assets that apply to the third-party effectiveness of a security right in specific types of asset, notably a right to payment of funds credited to a bank account and a right to receive the proceeds under an independent undertaking. Furthermore, in many of these States a security right in a movable asset that is attached to immovable property can be made effective against third parties by registration in the immovable property registry, either as an alternative or in addition to registration in the general security rights registry. Finally, under other law in many States, a security right in certain high-value mobile assets can be registered in a title registry (for example, a ship registry) or noted on a title certificate (for example, in the case of automobiles).

26. In some States, a separate regime is also established for receivables in the sense that it is possible to achieve third-party effectiveness of a security right in a receivable by notifying the debtor of the receivable about the existence of the security right. However, this approach conflicts with modern financing practices. An assignor generally will not want to alert its customers (the debtors of the receivables) as to the existence of a security right in its receivables because doing so may raise a question concerning the assignor’s financial condition in the minds of the customers. Indeed, even when receivables are assigned outright, the assignee will frequently wish to leave collection in the hands of the assignor. In any case, third-party effectiveness through notice to debtors of receivables cannot fulfil the function of a registry, since third parties would have to rely on representations by the assignor as to who these individual debtors might be. In light of these practices, this method of achieving third-party effectiveness increasingly is being abolished. Among States that have adopted a general security rights registry, notification of the debtor of the receivable is invariably treated simply as a collection or enforcement technique and not as a method for achieving third-party effectiveness. In these States, registration is seen as offering a more efficient means for assignees, including secured creditors, to evaluate priority risk at the outset of the transaction, in particular where the assignment covers all of the grantor’s present and future receivables. Otherwise, assignees would be subject to the risk of a loss of priority based on the decision of a competing assignee to give notice to the debtor on the receivable.

27. In most States, these alternative methods for achieving third-party effectiveness are not exclusive. For example, as noted above, most of these States provide that where a security right may be made effective against third parties by a transfer of possession to the secured creditor, it may also be made effective against third parties by registration. It follows that, where different types of asset are covered by the same security agreement, most

States provide that different methods may be used for different assets (see recommendation 36). The one exception to this principle of non-exclusivity recognized in the *Guide* flows from the particular character of letter-of-credit transactions (the *Guide* uses the term “independent undertaking”; see paras. 149-153 below and recommendation 35). This said, in States that have created a general security rights registry registration may, in practice, be an exclusive method of achieving third-party effectiveness of security rights in specific types of asset, in the sense that no other method is available to achieve third-party effectiveness for such types of asset (for example, receivables).

28. Notwithstanding the principle that an additional step is required in order to achieve third-party effectiveness of a security right, some States provide that, in a number of exceptional instances, a security right is automatically effective against third parties without the need for the secured creditor to register or take possession or perform any other step aimed at achieving positive publicity. One example recognized by some States and discussed in detail later in this chapter, is a security right in favour of a depositary bank in the grantor’s right to payment of funds credited to its bank account (see paras. 138-148 below). However, as a general rule in most States, a security right becomes effective against third parties only if it is made effective against third parties by a method that is designed to provide publically available information.

3. *Registration in a general security rights registry*

(a) *General*

29. While public registration is a well-accepted method of achieving third-party effectiveness, registry systems for security rights in movable assets differ widely. In many States, registration requirements have evolved incrementally over a long period of time, resulting in a patchwork of uncoordinated systems within the same State organized according to diverse criteria. Some of these systems may be organized by reference to the type of transaction (for example, retention-of-title and hire-purchase registries). Other systems may be organized by reference to the status of the grantor (for example, corporations or commercial enterprises) or by reference to the identity of the secured creditor (for example, banks). Still other systems may be organized by reference to the type of encumbered asset (for example, equipment or receivables).

30. States also take different approaches to the registration process and, in particular, to the question of what must be submitted by parties seeking registration. Some States require that a comprehensive summary of the rights set out in the security agreement be registered. Still other States go even further and require the full security documentation to be registered along with formal certificates or affidavits attesting to the identity of the participants and the authenticity of their signatures and legal capacity.

31. Especially in the latter part of the twentieth century, an increasing number of States came to establish new registries or to reorganize significantly or even replace their existing registries. Where existing systems were dispersed and fragmented, States replaced them with a central general registry covering all security rights in movable assets, regardless of the identity of the parties, the nature of the encumbered assets or the form of the transaction giving rise to the security right. Likewise, States that

established a registry for security rights in movable assets for the first time invariably opted for a central general registry.

32. Those States that reformed their registries in this manner also substantially changed the mechanics of registration. The goal was to substitute the registration of a simple notice containing only basic details about the security right to which it related for the more cumbersome system of registering either the security documentation or a certified summary of it. That is, in these systems, the security agreement that creates the security right is not registered, nor is its existence or content verified by the system. Such a registry is typically described as a notice-based registry as opposed to a document-based registry.

33. For many States, adoption of a notice-based registry constitutes a significant departure from the generally accepted concept of registration of security rights. Even in those States where full documentation is not registered, the idea of a document-based registry generally is that the registration provides searchers with actual or at least presumptive proof of the existence and scope of the security right referred to in the registration. In a notice-based registration system, by contrast, registration only provides notice that the secured creditor may have a security right in the assets described in the notice; as discussed in detail in chapter IV on the registry, registration may precede both the conclusion of the security agreement and the grantor's acquisition of rights in the encumbered assets described in the registered notice (see chapter IV on the registry, paras. 98-101).

34. Combined with a central comprehensive and computerized registry record, a notice-based registry system greatly simplifies the registration burden on secured creditors and offers a highly efficient and cost-effective registration and searching process. For these reasons, the *Guide* recommends that States establish a public registry that: (a) is centralized, general and comprehensive of all security rights; and (b) requires only the registration of a notice that sets out the basic details of the security right to which the notice relates. While the design and operational details of the system are addressed in detail in chapter IV of the *Guide* (see chapter IV on the registry, paras. 7-46) this chapter endorses the idea that registration of a notice of a security right in such a registry should be recognized as a generally available method of achieving third-party effectiveness for most types of movable asset (see recommendation 32).

(b) Registration is separate from creation of the security right

35. As noted in the preceding paragraphs, in a notice-based registration system of the kind recommended in the *Guide*, registration is effected by registering a simple notice containing only basic details about the security right to which the notice refers. The security agreement to which the notice relates is not actually registered, nor is its existence or content either shown to or verified by the registry. It follows that registration does not evidence the creation of the security right and it is not necessary for the creation of the security right (see recommendation 33).

36. Under this approach, whether a security right has actually come into existence cannot be determined from a search of the registry. Its existence depends on establishing (by reviewing evidence and documentation that is not part of the registry record) that the parties have satisfied the independent requirements for creation of a security right (see

recommendations 13-15). Similarly, the scope of the encumbered assets depends, to some extent, on the description set out in the security agreement and not in the registered notice. For example, if the description in the security agreement covers a narrower range of assets than the description in the registered notice, the description in the security agreement is determinative. Only where the description of encumbered assets in the registered notice is narrower in scope than that in the security agreement will the extent of third-party effectiveness be controlled by the description in the registered notice.

(c) Registration without creation is insufficient for third-party effectiveness

37. An important consequence of a notice-based registration system of the type recommended in the *Guide* is that registration is no guarantee of the actual existence of a security right. In other words, unlike traditional approaches to registration in many States, notice-based registration does not provide even presumptive evidence of the existence of the security right. This means that registration by itself does not result in third-party effectiveness of the security right referred to in the notice. That status is acquired only if and when the requirements for creation of a security right are also satisfied (see recommendations 29 and 32).

38. This approach to registration significantly increases the flexibility and efficiency of the secured transactions regime. To begin, while creation of a security right is a prerequisite to third-party effectiveness, it need not precede registration. As already explained (see para. 33 above), a notice of a security right may be registered either before or after a security agreement is entered into even before a security right in the assets described in the notice comes into existence (such as where the security agreement covers future assets).

39. While it is often the case that no great consequences flow from differences in the order in which creation of a security right and registration of a notice thereof occur, this is not always true. The time of creation is important if a third party acquires rights in assets described in a registered notice after registration takes place (for example, by gift or sale or as a result of insolvency or judgement enforcement proceedings). If the requirements for creation have also been satisfied by the time a third party acquires rights in encumbered assets, the security right will be effective against the third party and its priority will be determined according to the rules set out in chapter V. However, if the conditions for creation have not yet been satisfied, the third party will acquire the asset free of the subsequently created security right, notwithstanding that it has searched the registry and is aware of the notice filed by the secured creditor. Until both creation and registration have occurred, third-party effectiveness is not achieved.

40. The principle that third-party effectiveness dates from the time that both creation and registration occur, not simply from the time of registration, is subject to one important nuance in relation to questions of priority. As a general rule, in order to promote certainty and transparency of rights among secured creditors, priority among competing security rights that have been made effective against third parties by registration is made to depend on the order of registration, not the time of creation (see recommendation 76). That is, as between two secured creditors, one of which has registered first but has created its security right after the other has both created its security right and registered a notice (that is, has achieved third-party effectiveness), the first to register will have priority.

(d) *Extension of the scope of the general security rights registry to cover other transactions*

41. The establishment of a general security rights registry of the kind contemplated in the *Guide* enables searchers to discover potential security rights in a grantor's assets and to take steps to protect their rights. Some States that have adopted these types of registry have concluded that, even though the primary purpose of the registry is to serve as a repository of information about potential security rights, its scope can be expanded usefully to record information about other types of non-possessory right in movable assets.

42. The idea of using a general security rights registry for purposes other than recording notices about security rights is not novel. States that have established specialized registries to record security rights in claims to payment (for example, a right to a commercial receivable) sometimes also provide for registration of their outright assignment.

43. Among States that have adopted a general security rights registry, most subject an outright assignment of receivables to the same registration requirements and priority rules that apply to a security right in receivables. This is based on the rationale that there is little practical difference, from the perspective of the publicity needs of third parties, between an outright assignment and a security assignment and that, consequently, the rules for both types of transaction should be the same. This is the approach recommended in the *Guide* (see recommendation 32).

44. Some States that have adopted a general security rights registry also make registration a precondition to the third-party effectiveness of transactions that transfer possession, but not ownership, of tangible movable assets. The two most common situations involve operating leases of significant duration (for example, one year or longer) and commercial consignments in which the consignee is in possession of inventory as an agent for sale on behalf of the owner. The rationale for this approach is that, in the absence of registration, third parties dealing with tangible assets in the possession of a commercial enterprise have no objective means of determining whether those assets belong to the enterprise or to a lessor or consignor. In States that adopt this approach, the priority of the rights of the lessor and the consignor as against third parties are usually subject to the same rules that apply to the holder of an acquisition security right (see chapters V on the priority of a security right and IX on acquisition financing). The extension of the registration requirements for security rights to true leases is reflected at the international level in the Convention on International Interests in Mobile Equipment, in which the scope of the international registry contemplated by the Convention extends beyond security rights and financial leases to include operating lease arrangements.

45. With respect to immovable property, many States have long known of the concept of a judicial hypothec, under which a judgement creditor may register a judgement for a sum of money against the immovable property of the judgement debtor and thereby obtain an encumbrance on that immovable property. Among States that have adopted a general security rights registry, some also provide that registration of a notice of a judgement in that registry creates the equivalent of a security right in the movable assets of the judgement debtor identified in the notice in favour of the judgement creditor. This approach can indirectly promote the voluntary satisfaction of judgement debts, since third parties will be

unwilling to buy or take a security right in the judgement debtor's assets until the judgement debt is satisfied and the registered notice cancelled. The possibility that an enacting State may take this approach is accommodated in the *Guide* by the recommendation on priority between a secured creditor and a judgement creditor (see recommendation 84).

46. Among States that adopt this approach, some provide that the security right in favour of a judgement creditor ceases to be effective once insolvency proceedings are commenced against the grantor, either automatically or upon application by the insolvency representative, within a specified period of time after registration by the judgement creditor. In other States, the insolvency representative is entitled to assert the registered judgement creditor's security right for the benefit of all unsecured creditors (usually subject to a special privilege in favour of the registered judgement creditor to compensate for expenses and efforts). The purpose of both these approaches is to ensure that the registered judgement creditor's rights do not conflict with insolvency policies requiring equality of treatment among the debtor's unsecured creditors. The second approach seeks to achieve this objective while still enabling the insolvency representative to assert a priority for the benefit of all unsecured creditors as against secured creditors over whom the registered judgement creditor had priority prior to insolvency. The *Guide* does not make a recommendation on this point, since it is an issue for insolvency law rather than secured transactions law.

4. Possession

(a) General

47. In most States, a transfer of possession of tangible assets to the secured creditor (the classic possessory pledge) is accepted as sufficient both to evidence the creation of a security right and to make it effective against third parties. At the level of creation, this is based on the theory that the transfer of possession evidences the grantor's implicit consent to the security right and the scope of the assets encumbered by that security right. At the level of third-party effectiveness, a transfer of possession does not positively publicize the existence of a security right since the transferee's possession is equally consistent with a non-security arrangement (such as an operating lease or a mere deposit). However, the transfer of possession does eliminate the risk that the grantor's continued possession of the assets will mislead third parties into thinking that the grantor holds unencumbered title to the assets.

48. In some States, registration of a notice of a security right in a general security rights registry replaces possession and becomes the exclusive method of third-party effectiveness for security rights in movable assets (as it typically has done for immovable property). Three intertwined rationales are advanced for this approach. The first is that possession detracts from the reliability of the registry as a comprehensive source of information about the potential existence of security rights in a grantor's assets. Thus, prospective secured creditors or buyers cannot rely on a search of the registry to conclude that the relevant asset is unencumbered. To the contrary, they must also verify that the asset is still in the grantor's possession. The second rationale relates to difficulties of proof. Whereas registration establishes an objective time for the third-party effectiveness of a security right for purposes of determining its priority, a transfer of possession requires potentially

contested evidence of when the physical transfer actually occurred. The third rationale is that possession by the creditor may lead third parties falsely to believe that the creditor holds an unencumbered asset over which it may grant a security right. That is, a transfer of possession to the creditor does not itself provide a guarantee that the creditor in possession has the right to encumber the asset.

49. Despite these concerns, most States that have established a general security rights registry also retain transfer of possession as an alternative method for achieving third-party effectiveness with respect to security rights in certain types of asset. The reasons for doing so are several. The sufficiency of possession for third-party effectiveness is well established in commercial practice. In addition, transfer of possession as a method of third-party effectiveness would need to remain available in any event for negotiable documents and negotiable instruments in order to preserve their negotiability and the associated priority. Moreover, as for the intrusion on the comprehensiveness of the registry record, a prospective secured creditor or buyer will usually want to verify whether the relevant assets actually exist (since there is no general registry for title to movable assets) and, therefore, it will need to verify the grantor's continued possession. Evidentiary problems relating to the time of the transfer are unlikely to pose difficulties in practice. In its own self-interest, a prudent secured creditor will ensure that the time at which it acquired possession is well documented. Finally, given the nature of a secured creditor's business (for example, as a pawn-broker), third parties generally are not likely to be misled as to whether the creditor is in possession of the asset as owner or as a secured creditor (pledgee).

50. In States that accept both registration and creditor possession as alternative methods for achieving third-party effectiveness of a security right, as a practical matter the scope of the two methods is not the same. First, a transfer of possession is possible only if the asset in question is physically capable of being possessed (that is, it is a tangible asset). Second, transfer of possession is viable only where the grantor is prepared to give up ongoing use of the encumbered assets. It is not feasible if the grantor needs to retain the encumbered assets in order to provide its services, produce its products or otherwise generate income.

51. For these reasons, once a comprehensive and efficient notice registration system becomes available, the vast majority of secured creditors tend to prefer registration to possession as a method for achieving third-party effectiveness of a security right. The two main exceptions relate to specific transactions or assets and usually involve short-term financing. Thus, for example, where possession confers a priority advantage, as in the case of negotiable instruments and negotiable documents, secured creditors will want to take possession even if they may have already registered a security right (see recommendations 101 and 109). In addition, where the secured creditor is in the business of taking possessory security rights (as is the case with pawnbrokers), it is rare that it will also register its security right. Given that: (a) the possessory pledge is well known and well understood in most States; (b) there can be efficiencies in permitting possession as a method for achieving third-party effectiveness; and (c) the disruptions to the comprehensiveness of the registry are not significant, the *Guide* endorses registration of a notice and transfer of possession to the secured creditor as alternative methods for achieving third-party effectiveness of a security right in a tangible asset (see recommendation 37).

(b) *Constructive possession is insufficient*

52. Continued possession by the grantor or anybody closely associated with the grantor would not normally provide a sufficient signal to third parties that the grantor's title is potentially encumbered. Hence the long-standing principle that the traditional pledge requires the actual transfer of possession of the encumbered assets from the grantor (pledgor) to the secured creditor (pledgee). As noted earlier in this chapter (see para. 21 above), however, over time some States relaxed the rules as to what might constitute possession by the creditor. In some States, constructive possession (for example, an agreement appointing the grantor as the secured creditor's agent) came to be accepted as sufficient to constitute possession and give third-party effectiveness to a security right in tangible assets. In other States, symbolic possession became acceptable, such as when a grantor affixes a notice to an object or to the door of an establishment stating that the object or contents of the establishment have been pledged to the secured creditor. These developments were usually the result of States attempting to respond to the commercial demand for non-possessory security rights in the absence of a more general mechanism for making a non-possessory security right in movable assets effective against third parties. This said, many States that today do not permit non-possessory security rights nonetheless maintain a strict requirement that the creditor's possession be real: it must be public, continuous and unequivocal (for a discussion of possession as a condition of creating a possessory security right, see chapter II on the creation of a security right, para. 33).

53. States that have established a general security rights registry while continuing to allow creditor possession as an alternative method of third-party effectiveness generally adopt the strict approach to possession. Creditor possession requires real relinquishment by the grantor of physical custody over the encumbered assets. That is, because the existence of a security rights registry makes possible the granting of non-possessory security rights, there is no need to relax the concept of possession to facilitate non-possessory security rights. This is also the rationale of the *Guide* and the approach it recommends (see Introduction, section B, Terminology and interpretation, the term "possession" and recommendations 15 and 32).

(c) *Possession by a third party*

54. Most States take the position that a transfer of possession need not involve direct custody by the secured creditor in order to result in third-party effectiveness. Possession by an agent or representative of the secured creditor is equivalent to possession by the secured creditor, provided that an objective bystander would not conclude that the encumbered assets remain in the grantor's possession. There are various practical reasons why possession by a third party may be preferable.

55. In some cases, the secured creditor lacks the capacity to safeguard the encumbered assets properly. Here, a depositary acting for the secured creditor will typically take possession in the secured creditor's name. This may be useful, for example, in cases where the assets are diamonds, gold, silver or other precious metals that are best left in the safe keeping of a security company.

56. In other cases, the encumbered assets may already be in the possession of a third-party carrier or warehouse keeper. In this case, a form of third-party effectiveness through

possession can occur when the third party issues a receipt in the name of the secured creditor or agrees to hold the encumbered assets on behalf of the secured creditor; the third party's actions confirm that it is in possession on behalf of the secured creditor.

57. Alternatively, if the third-party carrier or warehouse keeper issues its receipt in the form of a negotiable document of title, this means the carrier or warehouse keeper is obligated to deliver the assets covered by the document to the person currently in possession of it. As discussed in this chapter (see paras. 154-158 below), delivery of the document with any necessary endorsement to the secured creditor therefore offers an alternative means of achieving third-party effectiveness of a security right in the assets it covers.

58. The possibility that possession of the encumbered asset by the secured creditor may be exercised through the custody of an agent or representative enhances the efficiency and effectiveness of possessory security rights by permitting creditors to delegate custodial responsibility without prejudice to the rights of third parties. For these reasons, the *Guide* confirms that creditor possession may be effected through third-party custody (see Introduction, section B, Terminology and interpretation, the term "possession" and recommendations 15 and 32).

59. In some States, the idea of third-party possession has been extended to eliminate the need for physical removal of the encumbered assets from the grantor's premises. In "field warehousing" arrangements, for example, a representative of the secured creditor (typically an employee of the grantor who becomes an agent for the field warehouse company) takes physical possession of the encumbered assets on the grantor's premises (for example, by placing them in a locked storeroom to which only the representative has the key). Any release of the assets in the field warehouse to the grantor requires the consent of the secured creditor through its representative.

60. Field warehousing arrangements are most common in States in which the possessory pledge is the only available form of security right in movable assets. In States that offer the alternative of a public registry, a secured creditor may still wish to engage in field warehousing as a practical technique for monitoring the movement of the encumbered assets. However, the secured creditor generally will also register a notice of its security right to ensure certainty with respect to third-party effectiveness even if the field warehousing arrangement is successfully challenged as involving merely a constructive rather than a real transfer of possession.

(d) Inapplicability of the concept of possession to intangible assets

61. Underlying the idea of possession as a possible method of achieving third-party effectiveness is the idea that physical custody of an asset is transparent. This is why States that authorize the creation of security rights through pledge agreements require the encumbered assets to be tangible assets. Intangible assets are excluded because it is not physically possible to take possession of an intangible asset. Very often, a creditor seeks to take a security right in the grantor's receivables, but cannot achieve third-party effectiveness of its security right in receivables by possession. Only if the receivables are made corporeal in a negotiable instrument is it possible for the creditor to achieve third-party effectiveness of its security right in the receivables by taking physical custody of the negotiable

instrument. To the contrary, if a secured creditor obtains physical custody of a deposit certificate or other instrument that merely evidences a debt but is not negotiable under the law governing negotiable instruments, this custody would not, in principle, constitute a method of achieving third-party effectiveness of the security right in the receivables evidence by such certificate or instrument. Likewise, should a grantor seek to create a security right in its right as a lessee of a piece of equipment, it could not achieve third-party effectiveness of that security right by handing over the equipment (which it does not own); nor could it achieve third-party effectiveness of a security right in its right as a lessee by handing over the lease contract to the secured creditor, because the lease contract is not a document of title (on the special rules applicable to possession of documents of title, see paras. 154-158 below).

(e) Adequacy of possession for the purposes of enforcement

62. Not all secured creditors will immediately seek to achieve third-party effectiveness of a security right at the time the security right is created. For whatever reason, they may neither register a notice in the general security rights registry nor take possession of the encumbered assets. In that event, it is necessary to determine the conditions under which subsequent possession by the creditor will still achieve third-party effectiveness.

63. Two types of situation are possible: a secured creditor may acquire possession prior to or after default of a grantor in the payment or other performance of the secured obligation. In the former case (pre-default possession), all States permit the creditor to achieve third-party effectiveness by possession simply by taking the encumbered asset from the grantor. Possession may be obtained either because it is voluntarily handed over by the grantor or as a result of the creditor obtaining a judicial order for possession (outside the process of enforcement of the security right) on the basis that this was a condition of the security agreement.

64. In the latter case (post-default possession), States take different approaches. In some States, a security right is not made effective against third parties by possession when possession results from seizure by the secured creditor as a result of the grantor's default. This approach has both a conceptual and a policy rationale. Conceptually, the voluntary surrender of possession by the grantor to the secured creditor at the outset of the secured transaction involves recognition by both parties that the secured creditor's rights against third parties are to be protected in this way. Seizure for the purposes of enforcement usually involves the involuntary relinquishment of possession of the encumbered asset by the grantor as a result of the grantor's default. Moreover, even where the grantor voluntarily surrenders the asset, it does so under the coercive threat of enforcement proceedings. The policy rationale rests on the fact that seizure for enforcement purposes typically will be relied upon by a secured creditor that has failed to register notice of its security right or has registered a defective notice. Especially in the context of a competition with the grantor's insolvency representative, there are concerns that recognition of seizure as a sufficient act of third-party effectiveness might reward imprudent conduct or encourage precipitous enforcement action or that it might involve difficult questions of proof as to whether the seizure occurred before or after the commencement of insolvency proceedings.

65. In other States, by contrast, the motivation and context of creditor possession is held not to be relevant to determining its legal consequences. In these States, creditor possession

results in third-party effectiveness even when the secured creditor obtains possession through seizure of the encumbered assets for the purposes of enforcement. This approach is based on the theory that the function of possession is to ensure that third parties are not prejudiced by the false impression of wealth that may arise from the grantor's retention of possession of assets to which it does not hold unencumbered title. Possession by the secured creditor serves this goal regardless of the motive for taking possession or the circumstances in which possession is obtained.

66. As noted, the primary context in which this policy issue arises involves a priority competition between a secured creditor and a grantor's insolvency representative. The *Guide* does not, therefore, contain a specific recommendation on the point, but defers to a State's insolvency regime (see UNCITRAL Insolvency Guide, part two, chapter V, paras. 57, 62-65 and 67-71).

5. *Registration in a specialized registry or notation on a title certificate*

(a) *General*

67. The two main approaches to achieving third-party effectiveness just reviewed (registration in a general security rights registry and creditor possession) presuppose that the central objective is to alert third parties to the possible existence of a security right. Even in States that have already established fragmented security rights registries, such as registries in which the organizational structure focuses on the type of transaction (for example, commercial pledge registries), the status of the grantor (for example, corporation registries), the type of secured creditor (for example, banks) or the type of encumbered asset (for example, equipment or receivables registries), the focus of the registry is on security rights. Only by exception are these registries available for registrations that are not or are not intended as security rights (for example, outright assignments of receivables, long-term leases and commercial consignments).

68. In many States, however, other ways to publicize rights have traditionally existed. On occasion, a specialized, asset-specific registry may be established to record all transactions related to that type of asset, including the acquisition and transfer of title to and security rights in an asset. The model for these types of registry is the standard registry of rights in immovable property, in which title, encumbrances, public servitudes and even caveats about impending litigation often can be registered. Common specialized registries for movable assets include registries for specific types of asset such as ships, aircraft and certain types of intellectual property such as patents, trademarks and copyrights. States have also created systems where certain types of movable asset are identified by a title certificate and various transactions relating to those assets (often including security rights) may be directly noted on the title certificate. These mechanisms have proved their usefulness over time, such that even in States that have established general security rights registries they are often maintained as alternative methods to registration and creditor possession for achieving third-party effectiveness.

(b) *Registration in a specialized registry*

69. The substantive and procedural rules governing registration in a specialized registry will normally be set out in the law that establishes the registry and any regulations related

to it. A general characteristic of specialized registries is that they are asset based (for example, a ship, aircraft, patent or trademark registry) and thus are open for the registration of rights in specific types of asset. Another characteristic is that specialized registries are first and foremost title registries. Because registration of an unauthorized transfer may prejudice the rights of a transferee or secured creditor that relies on the ownership registry record, in the case of a transfer of ownership specialized registration law typically requires registrants to provide evidence of the underlying transfer documentation. Depending on the specific applicable rules, the evidence required may range from registration of the full transaction documentation or a summary thereof to registration of a notice. Moreover, the legal consequences of registration of a security right in a specialized registry may differ, ranging from creation or third-party effectiveness to evidentiary, declaratory or regulatory effects. Thus, a specialized registry may serve not only to publicize rights and make them effective against third parties, but also serves important broader functions that cannot be replicated in a general security rights registry. For example, ship and aircraft registries are two widely recognized instances where a specialized registry functions to address international regulatory concerns about safety and national concerns of State security in addition to facilitating commercial transactions.

70. Where specialized asset-based title registries exist, States must initially determine whether security rights in specific assets may be registered in these registries. Many States do not permit such registration and creditors must resort to registering agreements like conditional transfers of title as a way of publicizing a security right. As already explained (see chapter I on the scope of application, paras. 110-112), the *Guide* does not favour maintaining these types of title device as a means for granting a security right. Consequently, the *Guide* assumes that where a State maintains a specialized registry, it will permit registration of a notice of a security right as a method of achieving third-party effectiveness of the security right (see recommendations 34, subparagraph (a) (iii), and 38, subparagraph (a)).

71. States that maintain specialized registries in which notices of security rights may be registered must determine whether registration in the specialized registry will be the exclusive method of achieving third-party effectiveness of security rights in the assets subject to registration in the specialized registry. The practice varies, even as between registries in the same State. Some States that permit registration of a notice of a security right in certain types of asset in a specialized registry as a method of achieving third-party effectiveness make such registration the exclusive third-party effectiveness method. No rights in the asset may be claimed by the secured creditor as against third parties if a notice or other document relating to those rights is not registered in the specialized registry. Other States adopt a less absolute position and permit alternative methods for achieving third-party effectiveness of security rights in assets covered by the specialized registry. In these States, the rationale is that, with the exception of competing claimants that seek to protect their rights by registration of a notice in the specialized registry and that have prejudicially relied on that registry, there is no reason why effectiveness against all other third parties could not be achieved by other generally available methods, including by registration in a general security rights registry or, where possible, by a transfer of possession of the encumbered assets. This is the approach recommended in the *Guide* (see recommendations 32 and 34).

72. However, in these States, when the security right was made effective against third parties by one of these other methods, its priority is subordinated to the rights of competing

secured creditors and transferees of the encumbered assets that register their rights in the specialized registry. Thus, as between a security right registered in the general security rights registry and one registered in the specialized registry, the former is subordinated to the latter regardless of the respective time of the registration in the two registries. Nonetheless, permitting third-party effectiveness also to be achieved by a registration in the general security rights registry enables a secured creditor that takes a security right in all of the grantor's movable assets or in generic categories of assets, to protect itself against the grantor's insolvency representative or judgement creditors by making a single registration in the general security rights registry.

73. Under this approach, registration in the specialized registry is necessary as a practical matter only if the secured creditor concludes that the risk of an unauthorized grant of security right to a competing secured creditor or a transfer to a transferee that registers in the specialized registry is sufficiently high to warrant the burden of making an additional registration in the specialized registry. In view of the limited number of these specialized registries and the types of asset they envision, giving priority to those rights that are registered in the specialized registry does not significantly compromise the efficiency and integrity of the general security rights registry. For these reasons, the *Guide* recommends that, where specialized registries are maintained, third-party effectiveness may nonetheless be achieved by alternative methods, such as registration in the general registry or creditor possession, subject to protecting the superior priority position of registrants in the specialized registry (see recommendations 38, 77 and 78).

74. Although the *Guide* makes no recommendation with regard to the law governing specialized registries, the efficiency rationale for adopting a notice-based registration approach for third-party effectiveness of security rights equally applies in principle to specialized registries. Thus, States maintaining such registries may wish to consider reforming their specialized registry law to permit registration of a notice of a security right as a method of achieving third-party effectiveness of the security right, incorporating into that law all the other features of a notice-based registration system (see chapter IV on the priority of a security right generally and, in particular, section A.10; see also recommendation 38).

(c) *Coordination of registrations in a specialized registry and in a general security rights registry*

75. The *Guide* is based on the assumption that where, under other law, notices or documents of security rights in certain types of asset may be registered in a specialized registry, third-party effectiveness of security rights in such assets may be achieved by registration in a specialized registry or in a general security rights registry (see recommendation 38). However, the *Guide* does not recommend registration of notices or documents of security rights in certain types of asset in a specialized registry where, under other law, this is not possible. Neither does the *Guide* recommend double registration of notices or documents of security rights in certain types of asset in every case.

76. A secured creditor may need to register a notice of its security right in the general security rights registry or a notice or document in the relevant specialized registry, depending on whether it wishes to ensure priority against all competing claimants. In

some cases, it will be sufficient for a secured creditor to register in the general security rights registry (for example, where it is not likely that there will be other secured creditors relying on a right registered in a specialized registry). In other cases, it will be necessary for a secured creditor to register in a specialized registry (for example, where it is likely that there will be other secured creditors relying on a right registered in a specialized registry or other third parties such as infringers of intellectual property). In still other cases, it will be in the interest of a secured creditor to register a notice of its security right in both registries. This will often be the case where the initial security right encumbers all of a grantor's assets and some of these are assets whose security rights are subject to registration in a specialized registry.

77. Rather than requiring the secured creditor in such cases to register in both types of registry, it may be desirable to establish a system in which security rights registered in the general security rights registry will be automatically forwarded for registration in the specialized registry and vice versa. In this way, a registrant will need to make only one registration in the general security rights registry or in the relevant specialized registry. A searcher will need to search only in the specialized registry because it will disclose not only security rights but also other rights. However, this approach will require coordination of registration systems and will create additional burdens on both registries and registrants. As specialized registries are asset-based, for a notice of a security right registered in the general security rights registry to be registrable in a specialized registry, the registrant will have to describe specifically the relevant assets in the notice. For example, the registrant would have to specify expressly that a notice covering "all tangible assets" includes the specific tangible assets (for example, ships or airplanes) subject to the specialized registry, and to describe these tangible assets in a manner required for registration in the specialized registry. Likewise, if the initial notice covered "all assets", the secured creditor would have to specify the specific patents or trademarks to be encumbered in language that would enable registration in the patents or trademarks registry (as the case may be) if it wished to have its security right over this intellectual property registered in the specialized patent or trademark registry.

78. In addition, for this system of forwarding of notices from the security rights registry to a specialized registry to work, the specialized registry will have to accept notices of security rights. To facilitate searches of security rights in assets of persons, the specialized registry should have, in addition to the typical asset-based index, a debtor-based index. Moreover, the registry staff would need to check the information in the notice and enter it into the system of the other registry. Such a requirement may be considered incompatible with the principle (addressed in detail in chapter IV of the *Guide* on the registry, paras. 13 and 16) that in the interest of efficiency and cost-containment, scrutiny by registry staff should not be a prerequisite to registration in the general security rights registry. Therefore, consideration should be given to permitting electronic forwarding of notices without any intervention of registry staff. Alternatively, it may be left to the secured creditor to make the registration in the separate system. This should not be an inordinate burden if the requirements for registration in the other system are adjusted to accommodate a simple notice-based registration process.

79. Similar difficulties would arise if a notice or other document relating to a security right registered in a specialized registry were to be forwarded to the general security rights registry. In addition, the information on record in the specialized registry would have to

be entered into the general security rights registry in a format acceptable to that registry; this burden could be placed on registry staff or on registrants. Moreover, the general security rights registry would have to maintain, in addition to the typical debtor-based index, an asset-based index to facilitate searches both by debtor name and by asset description.

80. An alternative to a system permitting the forwarding of notices from one registry to the other might be a system implementing a common gateway to both the general security rights registry and to various specialized registries. Such a common gateway would enable registrants to enter the notice simultaneously in both. Several steps would have to be taken in order to ensure the efficiency and effectiveness of a common gateway.

81. First, it would be necessary for the specialized registry to accept registrations of security rights by means of a simple notice of the type acceptable for the general security rights registry. Second, registrants would be required to include in the notice both the grantor's name (for the purposes of the general security rights registry) and a specific asset description in a form that would enable the notice to be registered in the specialized registry. In many cases, such as those involving descriptions of categories of assets, this specific description will have to be much more detailed than what is required for a notice registered in the general security rights registry. Third, a common gateway would only be efficient if it were also possible to search both registries through a single request. That is, a searcher may wish to know whether a specific asset that would fall within a category of assets charged by a security right registered in the general security rights registry is also the object of a specific registration in the specialized registry. While the searcher may know the grantor's name, in terms of the category of asset (for example, a ship or a patent) it may not know the specific asset identifier for that asset in the specialized registry. To enable the common gateway to function efficiently for searching, therefore, it would be necessary to maintain both grantor-based and asset-based indices and to ensure that these are cross-referenced.

82. While the *Guide* contemplates that States may wish to modernize their various specialized registries (see chapter IV on the registry generally and, in particular, section A.10), it does not make a specific recommendation as to how States should ensure the most efficient coordination of registrations that will be made in both the general security rights registry and any given specialized movable asset registry.

(d) Notation on a title certificate

83. Although most States have registration systems for the ownership and the transfer of ownership of motor vehicles and similar assets, these registry systems are generally not treated as establishing ownership for the purposes of commercial transactions. Rather their purpose is primarily regulatory, namely to enable the authorities to trace ownership in the event of an accident or a breach of criminal or safety standards and to allocate compulsory insurance liabilities and obligations. Because these registry systems do not serve as a mechanism to make the owner's rights effective as against third parties, they are not searchable by the public.

84. These regimes for motor vehicle registration usually provide the owner with a certificate of registration. A sale of the vehicle invariably requires the owner to relinquish the old certificate to the appropriate regulatory authority, which will then issue a new certificate in

the name of the new owner. In some States, the title registration certificate is used as a basis for publicizing security rights in the asset represented by the registration certificate. In these States, a notation of the security right on the face of the certificate is treated as sufficient to achieve third-party effectiveness of the indicated security right.

85. In States where this kind of certificate notation system is already in place and appears to be working well in practice, there may be little reason to abolish the system when a modernized regime of security rights is put into place. Nonetheless, it will be necessary to address the interrelationship of the existing system and the other methods of third-party effectiveness permitted under the new regime. Typically, notation on a title certificate is a sufficient method for obtaining third-party effectiveness of a security right in a tangible asset subject to the system. Registration in the general security rights registry and the taking of possession by the creditor are two other methods. However, if either of these latter methods is used, the priority of the security right to which they relate is typically subordinated to the rights of a competing buyer or secured creditor that has relied on the certificate notation system.

86. Given that these certificate notation systems deal with a very limited set of assets and are well understood in States that have adopted them, the creation of a superior priority right for those that use a notation certificate system does not significantly compromise the effectiveness of the general security rights registry. As with the approach taken to registration in a specialized title registry, this approach is intended to protect the reliability and integrity of the title certificate system while enhancing the flexibility and efficiency of the general secured transactions system. For these reasons, the *Guide* recommends both that a security right may be made effective against third parties by a simple notation on the title certificate and that the priority of a security right registered only in the general security rights registry will be subordinated to the rights of a competing claimant that has noted its rights on the title certificate (see recommendations 38, 77 and 78).

6. *Automatic third-party effectiveness of a security right in proceeds*

87. Encumbered assets may be sold and resold during the period when the secured obligation remains unpaid but not in default. Whether the sale is authorized (as is the case generally with inventory) or not authorized (as is usually the case with equipment) by the secured creditor in the security or other agreement, the sale or other disposition of encumbered assets will normally give rise to proceeds, whether in the form of cash, negotiable instruments, receivables, other assets received in exchange or some combination of the above. In some States, a security right in any proceeds (including proceeds of proceeds) derived from the original encumbered assets is automatically created as soon as these proceeds arise, provided they remain identifiable. As discussed in chapter II (see chapter II on the creation of a security right, paras. 72-85), this is the approach to proceeds recommended in the *Guide* (see recommendation 19). However, this is not the only question that needs to be addressed. It is also necessary to determine whether the secured creditor should have to register or take some other step to make the security right in the proceeds effective against third parties.

88. Although notices registered in a general security rights registry typically are organized and indexed by reference to the name or other identifier of the grantor, the registered

notice must also set out a description of the encumbered assets (see recommendations 57 and 63). Thus, it is necessary first to distinguish the situation where the security right in the original encumbered assets was made effective against third parties by registration of a notice that covers future assets and where the proceeds are of a kind that falls within the description of future assets in the registered notice. For example, if the registered notice describes the encumbered assets as “all present and future tangible assets” and the grantor sells a farm tractor and uses the proceeds to purchase a milking machine, the description in the registered notice covers the milking machine as original encumbered assets in the form of future tangible assets. As registration may be made in advance of the grantor’s acquisition of rights in the assets described in the registered notice, the original registration is sufficient to impart third-party effectiveness to the security right subsequently created in the milking machine when the grantor acquires rights in it. Consequently, States that provide for an automatic right in proceeds also provide for automatic third-party effectiveness in these cases. This is the result that is recommended in the *Guide* (see recommendation 39).

89. More difficult questions arise when the security right in the original encumbered assets is made effective against third parties either by registration of a notice that does not describe assets of the kind received as proceeds or by a method that would be insufficient to achieve third-party effectiveness if the proceeds were original encumbered assets. The first type of situation would arise, taking the example described above, if the registered notice described the original encumbered assets as “all present and future field equipment”; this description would not cover the milking machine. As for the second type of situation, if the original encumbered asset is a right to payment of funds credited to a bank account made effective against third parties by control and the grantor withdraws funds without authority in order to purchase a milking machine, the method of third-party effectiveness used for the original encumbered assets would not be sufficient for the proceeds.

90. These examples raise competing policy considerations. To give automatic third-party effectiveness to the security right in the proceeds undermines the policy underlying the third-party effectiveness requirements, since third parties would not be alerted to the potential existence of the security right in the proceeds. After all, a prospective purchaser of a milking machine from the grantor will not necessarily appreciate that a registered notice referring to a security right in field equipment (that is, the original encumbered assets) also covers the milking machine as proceeds (that is, the proceeds of the original encumbered assets). On the other hand, to require the secured creditor to take immediate steps to make the security right in the proceeds effective against third parties may impose a difficult monitoring burden and priority risk. The proceeds will often have arisen as a result of the grantor’s unauthorized dealing with the original encumbered assets. In such cases, the secured creditor usually will not become aware of the unauthorized disposition until well after the fact. If the disposition was, in fact, unauthorized, the secured creditor would generally be entitled to follow the original encumbered asset into the hands of a transferee and would therefore not suffer any prejudice. However, it may not always be possible after the fact to locate the asset or the transferee. In addition, in some cases the amount of the proceeds received might actually be higher than the value of the assets at the time it becomes necessary to enforce the security right. Thus, while the secured creditor cannot receive more than it is owed, it may be fully secured if it can rely on the value of the proceeds and under-secured if it can rely only on the value of the original encumbered assets.

91. In seeking to achieve a reasonable balance between these competing policies, the States that provide for an automatic security right in identifiable proceeds typically treat a security right in proceeds that would not be covered by the third-party effectiveness method used for the original encumbered assets as automatically effective against third parties, either permanently or only for a temporary period. The extent and duration of this automatic third-party effectiveness depends on the nature of the original encumbered assets and the nature of the proceeds.

92. Permanent third-party effectiveness generally is given to a security right in identifiable proceeds that take the form of money, receivables, negotiable instruments and rights to payment of funds credited to a bank account. This approach is based on the idea that the absence of an independent act of third-party effectiveness for these types of proceeds does not pose any significant risk of prejudicial reliance for third parties.

93. In the case of proceeds in the form of money and negotiable instruments, subsequent transferees or secured creditors that take possession are not prejudiced by the absence of an independent act of third-party effectiveness because they generally take these types of asset free of a security right in any event. A transferee of funds from a bank account generally takes the funds free of any security right. So, the absence of publicity does not prejudice its rights either. As for assignees (including secured creditors) of a right to payment of funds credited to a bank account, competing claimants are assumed to know that they risk subordination (or even loss of the security right where money is withdrawn from the account in circumstances that make it no longer identifiable), unless they protect themselves by assuming control of the bank account. The *Guide* provides recommendations dealing with the priority consequences of these principles in chapter V (see chapter V on the priority of a security right, paras. 154-164, and recommendations 101-106).

94. Given these considerations, States that recognize an automatic security right in proceeds usually extend permanent third-party effectiveness to proceeds in the form of money, receivables, negotiable instruments and rights to payment of funds credited to a bank account, provided that the security right in the original encumbered assets is effective against third parties when the proceeds arise. This is also the result recommended in the *Guide* (see recommendation 39).

95. For proceeds that take the form of other types of asset, a different set of policies are in play. To return to the earlier examples, suppose the initial security right was made effective against third parties by registration of a notice that describes the encumbered assets as “all present and future field equipment” and the grantor later exchanges a tractor for a milking machine. Alternatively, suppose the original encumbered asset is a right to payment of funds credited to a bank account made effective against third parties by control and the grantor withdraws funds without authority to purchase a milking machine. It may well be that the transactions giving rise to the proceeds are unauthorized and that the secured creditor does not quickly become aware of the disposition. In contrast to the types of asset addressed in the preceding paragraph, however, third parties could easily be prejudiced if third-party effectiveness of the security right created automatically in the milking machine were to be recognized as permanent. This would be so because, without explicit protection, third parties would take the milking machine subject to that security right even though the method of third-party effectiveness used for the original encumbered assets would not alert them to the security right automatically created in the milking machine as proceeds.

96. In order to avoid unduly undermining the rights of third parties, most of the States that recognize an automatic security right in proceeds of the kind addressed in the preceding paragraph limit its automatic third-party effectiveness to a short period of time after the proceeds arise. To achieve permanent third-party effectiveness, the secured creditor must register a notice or otherwise take positive steps to make the security right in the proceeds effective against third parties before the expiry of the temporary period. The temporary period is usually kept relatively short and yet not so short as to deprive a reasonably prudent secured creditor from the opportunity to take steps to preserve the third-party effectiveness of its security right (a period of 20-30 days is usually considered to be an acceptable compromise). The *Guide* adopts this logic of a short period of temporary automatic third-party effectiveness within which the secured creditor must take positive action to achieve the third-party effectiveness of its security right in proceeds if they are of a type different from the original encumbered assets and other than money, receivables, negotiable instruments and rights to payment of funds credited to a bank account (see recommendation 40).

7. *Third-party effectiveness of a security right in attachments*

(a) *General*

97. An asset encumbered by a security right that has been made effective against third parties may already be attached or may later become attached to other movable assets or to immovable property. For example, an engine already subject to a security right may be attached to a vehicle or a heating boiler already subject to a security right may later be attached to a building. In many States, once an encumbered asset becomes an attachment to another movable asset or to immovable property, the security right is automatically terminated. This approach is based on policy concerns about protecting the position of buyers and other third parties that subsequently acquire rights in the assets to which the encumbered asset is attached. Where the original encumbered asset becomes an attachment to immovable property, there is the additional policy concern that subsequent detachment in the context of the enforcement of the security right may result in excessive damage to the immovable property.

98. States that have adopted a comprehensive registry system for movable assets typically permit the security right in an asset to survive attachment to another asset, at least as between the parties. However, in order to address the respective rights of the secured creditor and third parties, these regimes also provide a full set of third-party effectiveness and priority rules. This is the general approach recommended in the *Guide*. Thus, chapter II on the creation of a security right confirms that a security right may be created in a tangible asset that is already an attachment at that time or becomes an attachment subsequently (see recommendation 21). This chapter addresses the issue of third-party effectiveness, while chapter V deals with priority. As for the additional policy concern that is present in the case of attachments to immovable property whose subsequent detachment may cause excessive damage to the immovable property, this is addressed as an issue relating to the enforcement of a security right (see chapter VIII on the enforcement of a security right, paras. 85-89).

(b) *Attachments to movable assets*

99. A security right may be created in a tangible asset either before or after it becomes an attachment (see recommendation 21). Whether the security right in the tangible asset is created before or after the asset becomes an attachment, the general requirements for obtaining third-party effectiveness are applicable. In both cases, attachments are not singled out for special treatment.

100. The application of this principle to security rights created after the encumbered asset becomes an attachment means that, if the security right is made effective against third parties by registration prior to attachment, it remains effective after attachment without the need for any further step (see recommendation 41). This is because, unlike the situation where the original encumbered asset is replaced by proceeds, attachments retain their discrete identity after they are attached to other assets and there often is little danger of confusion. Thus, it is reasonable to assume that a third party that searches the registry for security rights in the assets to which the encumbered asset is attached (for example, an automobile) will understand that a registered notice that describes the attachment (for example, automobile tyres) may refer to the tyres installed on the automobile in which the third party is interested.

101. Theoretically, a security right in an attachment would also remain effective against third parties if the security right had been made effective prior to attachment by a transfer of possession (either to the secured creditor or to a third-party agent of the creditor) rather than by registration in the general security rights registry. However, as a practical matter, third-party effectiveness will typically cease upon attachment, since the secured creditor will normally have to relinquish possession to allow the attachment to take place. Consequently, third parties that deal with the asset after attachment will take free of the security right, unless the secured creditor preserves its status by registering in the general security rights registry before giving up possession or before the rights of the third parties arise. By contrast, in the unusual case where the secured creditor is already in possession of the movable asset to which the attachment is made, third-party effectiveness is preserved.

(c) *Attachments to immovable property*

102. If an encumbered asset is attached to immovable property, the policy considerations are more complex. This is because any rights that encumber immovable property normally will be registered in the immovable property registry. As between the parties, the *Guide* recommends in chapter II that a security right in an attachment to immovable property may be created either according to the principles elaborated in the *Guide* for the creation of a security right or according to the regime for the creation of an encumbrance on immovable property (see recommendation 21). Consistent with this idea, the security right so created may be made effective against third parties either by registration in the general security rights registry or by registration in the immovable property registry (see recommendation 43).

103. However, the choice between these two methods for achieving third-party effectiveness has priority consequences. In order to preserve the reliability and integrity of

the immovable property registry, most States that have both types of registry provide that a secured creditor or buyer that registers in the immovable property registry has priority over a secured creditor that registers only in the general security rights registry. Thus, registration in the immovable property registry is necessary to achieve maximum protection against third parties. This is the approach recommended in the *Guide* (see recommendation 87).

104. This approach is workable only if registration of a security right in an attachment in the immovable property registry can be done easily and efficiently. Many immovable property registry systems require the submission of full security documentation or impose other formalities such as proof of a notarial certificate for registering encumbrances on immovable property. If this is the case, land registration laws may need to be revised to authorize secured creditors to effect registration of a security right in an attachment in the immovable registry through submission of the same form of simple notice used for registration in the general security rights registry. Otherwise, the cost and expense involved in fully protecting their priority status by registering in the immovable property registry may deter secured creditors from engaging in secured financing that involves attachments to immovable property.

(d) Attachments to assets subject to a specialized registration or title certificate system

105. In those States that have specialized title registries or title certificate systems, the types of asset subject to these systems may include assets to which other tangible assets are normally attached (such as an engine on an aircraft). Logically, the approach taken to a security right in tangible assets that are attached to immovable property should extend to the case of attachments to assets subject to a specialized title registry or title certificate system. Under this approach, a security right in the attachment may be made effective against third parties either by registration in the general security rights registry (or by the creditor taking possession, although this will be rare), on the one hand, or by registration in the specialized registry or notation on the title certificate, on the other hand (see recommendation 42).

106. As with attachments to immovable property, in order to protect the integrity and reliability of specialized registration systems, registration in a specialized registry or notation on a title certificate is necessary to achieve maximum third-party protection. That is, a secured creditor or buyer that relies on the specialized registry system has priority over a secured creditor that achieves third-party effectiveness by registration of a notice in the general security rights registry or some other method (see recommendation 89).

107. The *Guide*'s approach to third-party effectiveness of security rights in attachments to tangible assets, which are subject to specialized registries or title certificate systems, is identical to its approach to third-party effectiveness of security rights initially taken in such assets (see recommendations 38, 77 and 78). For this reason also, the observations about how to achieve an efficient and effective coordination of registrations in both the general security rights registry and any given specialized registration or title certificate system are equally applicable in the case of attachments (see paras. 75-86 above).

8. *Automatic third-party effectiveness of a security right in a mass or product*

108. For the reasons set out previously (see chapter II on the creation of a security right, paras. 90-95 and 100-102), the *Guide* recommends that a security right in tangible assets that are later processed or commingled automatically continues in the finished product or commingled mass (see recommendation 22). This recommendation does not, however, speak to whether the security right in the finished product or mass is effective against third parties. Assuming the security right in the component asset was made effective against third parties prior to the processing or commingling, the policy question is whether the security right that continues in the product or mass should be treated as automatically effective against third parties.

109. In the most common case, the security right in the original encumbered assets will have been made effective against third parties by registration in the general security rights registry (indeed, this is the only practical method available for security rights in inventory in the form of raw materials where the grantor must retain possession of the inventory for use in its business). It follows that States have to decide whether this initial registration is sufficient to achieve third-party effectiveness of the security right in the product or mass derived from the processing or commingling of the original encumbered assets.

110. As already noted, while notices in a general security rights registry are organized by reference to the identity of the grantor, the registered notice must include a description of the encumbered assets (see recommendations 57 and 63). Just as with security rights in the proceeds of disposition of encumbered assets, a distinction must be drawn based on the scope of the description of the original encumbered assets in the registered notice.

111. Consider first the situation where the registered notice describes the encumbered assets in a manner that covers the resulting product or mass. For example, a registered notice may describe the encumbered assets as “all present and future wheat of a certain type or quality” and the grantor’s wheat later may be commingled with other wheat of the same type or quality. Another example would be where a security right is taken in resin that is later manufactured into chipboard and the registered notice describes the encumbered assets as “all present and future raw materials and finished products”. In both cases, the description of the encumbered assets adequately alerts a third-party searcher to the possible existence of a security right in the commingled mass or the manufactured product. Thus, there can be no policy objection to treating the original registration as sufficient to extend third-party effectiveness to the security right in the future product or mass. For this reason, most States that have adopted a modern security rights regime take the position that, where a security right is made effective against third parties by a method that would be sufficient to give third-party effectiveness to a product or mass resulting from the original encumbered assets, the security right in the product or mass is automatically effective against third parties (see recommendation 44).

112. More difficult policy concerns arise where the registered notice describes the encumbered assets in terms that do not cover the commingled mass or the finished product. For example, the secured creditor may have registered a notice that describes the encumbered asset as wheat of a certain type or quality and the wheat is then irretrievably commingled with a much greater quantity of wheat of a different type or quality. A third

party searching the registry may not understand that wheat of one type or quality mixed with wheat of a different type or quality includes the original encumbered asset. An even more difficult situation arises where the secured creditor registers a notice that describes the encumbered asset as “resin” and the resin is later processed into chipboard. Here, a third party that searches the registry to determine whether there is any security right in the grantor’s chipboard may not understand that a notice referring to a security right in resin also extends to chipboard manufactured from the resin.

113. This second situation, especially, raises competing policy considerations. To give automatic third-party effectiveness to the security right in the chipboard may compromise the policy underlying the third-party effectiveness requirements, since the registered notice does not necessarily alert third-party searchers to the existence of the security right. However, to require a secured creditor to also include a description of the resulting product or mass in its registered notice may discourage financing against the security of a grantor’s raw materials or lead to the registration of notices containing overly broad descriptions (as in the example given above where the notice refers to “raw materials” even though the security right is limited to resin) thereby impairing the grantor’s access to secured credit from other sources.

114. In resolving these competing policies, States take different approaches. In some States, the security right is treated as automatically effective against third parties without the need for any further act. This approach is based on the theory that the risk of detrimental reliance by third parties is minimal in practice. Subsequent secured creditors will be sufficiently knowledgeable about the grantor’s manufacturing operations to understand that a registered notice that refers to a security right that describes only the component assets also covers any finished product processed from those assets. Subsequent buyers will generally be protected since the finished product or commingled mass will typically constitute inventory sold in the ordinary course of the grantor’s business and a buyer in the ordinary course of business in any event takes free of any security right.

115. In other States, the security right is treated as automatically effective only as against other secured creditors. If the competition is with someone other than another secured creditor (for example, a buyer other than a buyer in the ordinary-course-of-business, a judgement creditor or an insolvency representative), the security right is ineffective unless a notice that describes the encumbered asset in terms that include the product or mass is registered before these other rights arise. This approach is based on the theory that, unlike the grantor’s secured creditors, these other categories of competing claimants are more likely to be misled by a description in a registered notice that includes only the raw materials and not the finished product into which they are incorporated.

116. The *Guide* recommends the first of the two approaches just outlined. That is, it recommends that, if the security right in the component asset is effective against third parties, the security right in the resulting product should automatically be effective against third parties without the need for the secured creditor to take any further step (see recommendation 44). This choice is based on two considerations. First, in practice the finished product or commingled mass will almost invariably constitute inventory that is then sold to a buyer in the ordinary course of business and the buyer will take this inventory free of the security right in any event (see recommendation 79). Second, unsecured creditors generally do not look to a grantor’s inventory for the purpose of satisfying their

judgements, since the grantor is more likely to be in a position to pay their claims if it is able to continue selling its inventory in the ordinary course of business.

9. *Continued third-party effectiveness of a security right after a change in the location of the asset or the grantor*

117. The possibility of a change of location is inherent in the nature of movable assets. People and enterprises are also mobile and can likewise change their location. As explained in chapter X on the conflict of laws (see paras. 73-78), the law applicable to the third-party effectiveness of security rights is determined by reference to the current location of either the encumbered assets or the grantor, depending on the nature of the encumbered assets (see recommendations 203, 208 and 219-220). The use of current location (as opposed to location at the time of the creation of the security right) is based on the theory that third parties that deal with the encumbered assets or the grantor cannot be expected to undertake an historical investigation into whether the encumbered assets or the grantor were previously located in a different State. However, this approach potentially creates significant risks for secured creditors. Third-party effectiveness ceases as soon as the location of the assets or the grantor (depending on which is the relevant connecting factor for applicable law) changes, unless the security right is made effective against third parties under the law of the new location. While the secured creditor can protect itself if it has advance knowledge of the change of location, in the typical situation this will not be the case.

118. In an effort to balance the rights of secured creditors and third parties in this situation, some States provide a period of temporary automatic third-party effectiveness following a relocation of the encumbered assets or the grantor, depending on which is the relevant connecting factor for the security right in question. Under this approach, a security right that was made effective against third parties under the law of the previous location is treated as automatically effective against third parties for a short grace period after the relocation under the law of the State to which the assets were transported or the grantor moved. If the security right is made effective against third parties in accordance with the law of the new location before the expiry of this period, it continues to be effective against third parties that acquire rights in the encumbered assets after the relocation. This is the case even if the competing third-party rights were acquired before the security right was made effective against third parties under the law of the new location, provided that third-party effectiveness was achieved before the expiry of the grace period. Some States do, however, protect buyers in this situation on the theory that buyers do not necessarily have the acumen or resources to investigate the antecedent location of the purchased asset or appreciate that it may be subject to a registered security right in another State. Conversely, if third-party effectiveness in accordance with the law of the new location is not achieved before the expiry of the specified grace period, the security right is ineffective against third parties that acquired rights during the grace period and thereafter up to the time that the security right is made effective against third parties under the law of the new location.

119. The *Guide* adopts this approach (see recommendation 45), on the theory that it offers a reasonable balance between accommodating the rights of secured creditors and those of third parties that deal with the assets or the grantor following relocation. On the one hand, the secured creditor is given a reasonable time period to take action to protect

its rights. On the other hand, a defined time period enables a third party that acquires rights in the encumbered asset after the relocation to take effective protective measures, such as withholding a loan or disbursement of credit or adjusting the purchase price pending the expiry of the short period of automatic third-party effectiveness, since the third party can rely on taking free from any foreign security right not otherwise made effective against third parties before the expiry of that period.

10. Continuity and lapse of third-party effectiveness

120. As already mentioned, most States that have adopted a general security rights registry system also permit alternative methods for achieving third-party effectiveness (such as possession by the creditor, control with respect to rights to payment of funds credited to a bank account, registration in a specialized registry or notation on a title certificate). Sometimes, a secured creditor concurrently uses more than one method to achieve third-party effectiveness for a particular type of encumbered asset. Moreover, sometimes a creditor may change the method by which third-party effectiveness is achieved (for example, a secured creditor that has taken possession may later register a notice of the security right in the general security rights registry). Most States that recognize alternative methods of third-party effectiveness provide that continuity of third-party effectiveness is preserved notwithstanding a change in the method of third-party effectiveness, as long as there is no time when the security right is not effective against third parties under at least one method.

121. As already discussed, the policy rationale for third-party effectiveness requirements is to enable potential secured creditors and other third parties to determine relatively easily whether a security right might already encumber the assets in which they propose to acquire rights. When different methods for achieving third-party effectiveness are permitted, this policy rationale is satisfied regardless of the method a creditor selects. Hence, as long as there is no time at which the security right is not effective against third parties, the secured creditor should be able to change the method for achieving third-party effectiveness without interrupting the third-party effectiveness of its security right. This is the approach recommended in the *Guide* (see recommendation 46). However, a change in the method may have priority consequences. For example, if a creditor first registers a security right in an attachment in the immovable property registry, then registers a notice about it in the general security rights registry and after that cancels the registration in the immovable property registry, the security right will maintain its third-party effectiveness but will lose the preferred priority position that comes with registration in the immovable property registry. These priority consequences of a change in the method of achieving third-party effectiveness are discussed in chapter V on the priority of a security right (see paras. 132-134).

122. Conversely, there can be situations where third-party effectiveness lapses. Consider the case where the requirements for third-party effectiveness under one method are no longer satisfied and the secured creditor does not achieve third-party effectiveness through another permissible method before the time when the first method lapsed. For example, registration may expire or be cancelled, the secured creditor may relinquish possession of the encumbered asset or the circumstances that resulted in automatic third-party effectiveness may no longer prevail, but the secured creditor has not taken steps to

achieve third-party effectiveness using another method prior to the lapse of the original third-party effectiveness.

123. States take different approaches to the effect of re-establishing third-party effectiveness after a lapse. Some States consider that the lapse is fatal to the continuity of third-party effectiveness and any re-establishment is effective only from the time of re-establishment onwards. The policy here is to avoid requiring a third party to go beyond the registry record in order to determine if a security right ever existed. Other States provide for a grace period within which a lapsed registration may be re-established. In these States, if third-party effectiveness is re-established before the expiry of the grace period, it will be deemed to have been continuous and the initial priority of the secured creditor will be maintained, except as against competing claimants that acquired rights in the encumbered assets during the period between the lapse and the re-establishment. The policy here is to permit a secured creditor that may have inadvertently let third-party effectiveness lapse to correct its mistake, as long as no third party suffers prejudice as a consequence. In still other States re-establishment of third-party effectiveness at any time after lapse preserves continuity of third-party effectiveness, subject again to the rights of intervening competing claimants.

124. In deciding which of these three approaches to adopt, it is helpful to analyse the general consequences likely to flow from a failure to preserve continuity of third-party effectiveness. Two situations are particularly telling. The first is where a third party (such as a buyer, insolvency representative or judgement creditor) acquires rights in the encumbered assets after a lapse and before third-party effectiveness is re-established. As the security right was not effective against third parties at the time when such a third party acquired its rights, a buyer will take the encumbered assets free of the security right, while the right of an insolvency representative and a judgement creditor will have priority over the security right. All of the approaches discussed above will produce this result.

125. The second instance of concern arises where the security right, prior to the lapse, had priority over a competing security right. Priority among competing security rights, as a general rule, is based on the order of registration or third-party effectiveness (see recommendation 76). Under the first approach, if third-party effectiveness lapses, priority dates only from the time when it is re-established. The lapsed security right will be subordinated to a competing security right that is registered or made effective against third parties before or during the period of lapse. Under the second and third approaches, since the re-establishment of third-party effectiveness is deemed to relate back to the initial time of third-party effectiveness, the security right regains its pre-lapse priority over competing security rights, but (as noted in the preceding paragraph) not against security rights made effective against third parties during the period between the lapse and the re-establishment.

126. The discussion in the preceding paragraph considers registration as distinct from third-party effectiveness. The reason for this is that, unlike the other modes of third-party effectiveness, registration may precede creation of the security right. Even though the requirements for creation may not yet be satisfied, the security right ranks against competing security rights from the time of registration, not the subsequent time of creation. As a result, the important event is the time of lapse in registration and not the time of creation of the security right.

127. There are good policy reasons for all three approaches. However, the second and third approaches can complicate the assessment of priority in situations where the holder of a security right whose third-party effectiveness has lapsed then regains its priority over a pre-lapse competing secured creditor by re-establishing third-party effectiveness, but a third competing secured creditor has entered the picture during the lapse period. This creates the potential for a circular priority dispute. For example, while the security right whose third-party effectiveness lapses has priority over the pre-lapse security right, it is subordinate to the third intervening security right, which in turn has priority over the lapsed security right. The only difference between the second and third approaches is that the second approach seeks to limit the potential for this complication to occur by limiting the time period for re-establishment of third-party effectiveness. In addition, adoption of either of these two approaches requires the registry record to be configured to enable revival of or a reference to the original registration record to ensure transparency. To avoid these complications and in the interests of providing a clear and efficient registration and priority regime, the *Guide* recommends the first approach. If a registration lapses or if third-party effectiveness lapses because the requirements of one third-party effectiveness method are no longer satisfied before another method is substituted, in either case, the registration may be renewed or third-party effectiveness may be re-established, but only from that time forward (see recommendation 47).

B. Asset-specific remarks

1. *Third-party effectiveness of a security right in a personal or property right securing payment of a receivable, negotiable instrument or any other intangible asset*

128. Very often, receivables, negotiable instruments and other intangible assets are secured by a personal guarantee or a security right. For example, a grantor in the business of selling assets on credit may have a security right in the sold assets to secure the buyers' payment obligations. Where the grantor is itself a lender, its customers' payment obligations may be backed up by additional security, such as a personal guarantee from a third party.

129. In most States, accessory personal or property security rights automatically follow the obligation they secure. That is, should the creditor of a receivable or the holder of a negotiable instrument that is backed by a security right or a personal guarantee transfer the receivable or negotiable instrument to a third party, the transferee will acquire the benefit of these accessory rights in addition to the right to payment of the obligation they secure. This result flows from general principles of the law of obligations in most States and is the approach recommended in the *Guide* (see recommendation 25).

130. The idea that accessory security rights and personal guarantees automatically follow the receivable, negotiable instrument or other principal obligation also generally applies to security rights granted in the receivable or negotiable instrument. That is, a secured creditor that obtains a security right in a payment obligation automatically acquires the benefit, as against the grantor, of any accessory rights held by the grantor against third parties as soon as the security right in the payment obligation is created. However, the question at issue here is whether, if the security right in the receivable or negotiable instrument has been made effective against third parties, third-party effectiveness should automatically extend to the accessory rights without the grantor or the secured creditor being

required to undertake any further act. Most States adopt this approach on the theory that third parties are not prejudiced because they can be taken to understand that the accessory rights are an integral part of the principal encumbered asset. Accordingly, this is the approach recommended in the *Guide* (see recommendation 48).

131. The secured creditor's right to enforce an accessory security right against third parties also depends on whether the accessory security right is effective against third parties and is enforceable by the grantor at that time. For example, if the grantor failed to take the necessary steps to make a security right in tangible assets securing a payment obligation effective against third parties, a secured creditor that acquires a security right in the obligation will obtain only a correspondingly limited right in the accessory security right.

(a) *Independent undertakings*

132. Additional policy considerations are present, however, if the personal or property right securing the principal obligation is an independent undertaking. States take different approaches in this case.

133. In some States, these rights follow the payment obligation that they secure only if they are transferable and the transfer is made in a separate juridical act. This approach is based on the assumption that, while accessory rights are expected by parties to be transferred automatically with the obligations they secure, the very fact of the independence of an independent undertaking means that parties would normally have the contrary expectation. In other States, even independent security and other rights automatically follow the obligation they secure without the need for a new act. This approach is based on the assumption that the secured creditor will normally request the grantor to transfer all rights securing the grantor's receivable and that simplifying the achievement of that result will save time and expense and thus have a beneficial impact on the availability and the cost of credit.

134. This second approach is also based on the assumption that the rights of third-party obligors of independent rights (such as an independent undertaking) may be protected through separate rules. For example, in the case of a security right in the right to receive the proceeds under an independent undertaking, third-party effectiveness automatically extends to the right to receive the proceeds under the independent undertaking, but does not extend to the right to draw (that is, the right to ask or to require the obligor to make the payment), which is an independent right (see recommendation 25, subparagraph (b)). As a result, the obligor under an independent undertaking is protected against being required to pay to a third party (the secured creditor), and thus there is no reason not to extend automatically the third-party effectiveness of the secured creditor's rights to whatever rights it may claim in respect of the independent undertaking. For these reasons, this second approach is the one recommended in the *Guide* (see recommendation 48).

(b) *Receivables secured by an encumbrance on immovable property*

135. Situations where the payment of a receivable is secured by an encumbrance on immovable property (that is, a mortgage, hypothec or other equivalent encumbrance on immovable property) raise additional policy considerations. As already discussed (see

para. 130 above), the general rule in most States and the one recommended in the *Guide* is that, if a security right has been made effective against third parties, third-party effectiveness automatically extends to any accessory security rights securing payment of the principal obligation without the need for any further act. In some States, however, the law of immovable property requires that a notice of the security right be given to the grantor of the encumbrance on immovable property in order for the creditor with security in the receivable to benefit from that encumbrance. As a secured creditor cannot benefit from any greater rights than those of the assignor of the receivable, the need for this limitation is questionable and the *Guide* does not recommend it.

136. In other States, a security right in a receivable secured by a mortgage or other encumbrance on immovable property can only be made effective against third parties by registration in the land registry. This approach is based on the theory that third parties interested in acquiring the benefit of an encumbrance on immovable property would usually expect to find any competing encumbrances recorded in the land registry as opposed to a general security rights registry for movables (in particular since it is unusual and, in many States, legally impossible to assign the receivable secured by an encumbrance on immovable property independently of that encumbrance). In still other States, the security right in the receivable can be made effective against third parties under the security regime applying to movable assets, but the security right is subordinate to the right of a secured creditor that registers in the immovable property registry. While the *Guide* recommends automatic extension of the third-party effectiveness of the security right in the receivable into the encumbrance on immovable property that secures its payment (see recommendation 48), it also acknowledges that overriding policies in respect of immovable property law may lead States to follow these other approaches.

137. As previously noted, in some States it is possible for a secured creditor to transfer an encumbrance on immovable property separately from the principal obligation that the encumbrance secures. States that permit the creation of these types of independent encumbrance on immovable property do so primarily to facilitate the transfer of such encumbrances. Often the specialized financing practices associated with such independent encumbrances are carefully specified in the land law of a State; sometimes they are not and result from judicially recognized contractual practices. In either case, the policy considerations relating to the possibility of creating such an independent encumbrance and the effects of such security devices are closely tied to a State's land law. For this reason, the *Guide* recommends that the automatic extension of third-party effectiveness to rights securing the payment of the receivable or negotiable instrument should not apply where the right in question is characterized as an independent encumbrance on immovable property (see recommendation 48).

2. *Third-party effectiveness of a security right in a right to payment of funds credited to a bank account*

138. Funds credited to a bank account are an increasingly important asset that grantors may offer as security for credit. The asset over which security right is granted is not, in fact, the bank account itself, but rather the grantor's right to claim performance of the bank's obligation to pay the value of the funds credited to the grantor's bank account (see chapter II on the creation of a security right, para. 123).

139. States take different approaches to the requirements for third-party effectiveness of a security right in this type of asset. Among States that have not established a general security rights registry, most States simply apply the general rules for achieving third-party effectiveness of security rights in receivables. Sometimes this means registering a notice in a special registry devoted to the assignment of, or the creation of security rights in, receivables, although sometimes the secured creditor is also required to give written notice of the security right to the holder of the bank account.

140. Among States that have established a general security rights registry, some classify a right to payment of funds credited to a bank account in the same way as any other receivable. As noted earlier, registration is usually the only practically available method for achieving third-party effectiveness in receivables in these States. Consequently, in these States the third-party effectiveness of a security right in a right to payment of funds credited to a grantor's bank account can be achieved only through registration in the general security rights registry.

141. Other States with a general security rights registry have devised a specialized set of third-party-effectiveness rules based on the secured creditor obtaining "control" with respect to the right to receive payment of funds credited to a bank account. If the secured creditor is the depositary bank, control and third-party effectiveness are automatic. Other secured creditors can obtain control in either of two ways. One method is for the secured creditor to be substituted for the grantor as the bank's customer on the account. While this creates the functional equivalent of the classic possessory pledge, it is impractical for a grantor that requires free access to its accounts in the ordinary course of its business. Consequently, the other method, known as a "control agreement", is the method mostly used in practice. In this case, control is achieved through an agreement among the grantor, the secured creditor and the bank. As with the automatic control that may be achieved by the depositary bank, a control agreement does not result in a blocking of the funds unless the control agreement so provides. Often, the control agreement will provide that the grantor's access to the funds is blocked only upon the occurrence of a default by the grantor to the secured creditor and the secured creditor's delivery of an instruction to the depositary bank to block such access. However, third-party effectiveness by control may be achieved in this circumstance even when the grantor remains free to draw on the account until the secured creditor notifies the bank otherwise.

142. Under both of the two general approaches (registration or control) adopted by States with general security rights registries, a transferee of funds from a bank account under a transfer initiated by the grantor takes the funds free of the security right. However, the two approaches have quite different priority consequences. Under the first approach, priority generally turns on the order of registration of the security right. Where the depositary bank is also a secured creditor, it does not enjoy any special priority status as a secured creditor (although it typically has a right under other law to set off any claims it has against the grantor against a demand for payment by a prior-ranking secured creditor, and this normally means that it has a *de facto* priority). Under the second approach, a depositary bank with automatic control has priority over other secured creditors, except one that achieves control by replacing the grantor as the bank's customer on the account.

143. The first approach has the advantage of clarity and simplicity, whereas the second approach requires the elaboration of a fairly complex set of specialized creation,

third-party effectiveness and priority rules. The first approach ensures transparency through public registration, whereas the depositary bank under the second approach is not obligated to disclose whether it has acquired a security right in its own favour or entered into a control agreement with another secured creditor. The first approach does not privilege the depositary bank when it exercises its rights as a secured creditor, whereas under the second approach the depositary bank generally has priority over other secured creditors. In addition, the grantor is free to create a security right in favour of another creditor under the first approach, whereas the depositary bank under the second approach is not obliged to enter into a control agreement even at the grantor's direction. Finally, public registration under the first approach may be more cost- and time-efficient than the tripartite negotiations required to negotiate and enter into a control agreement under the second approach.

144. However, the second approach is, in some respects, more solicitous of practical banking concerns. Automatic control in favour of the depositary bank is analogous to the situation under the law of set-off, which permits a depositary bank to apply funds credited to its customer's account and therefore owing to the grantor against any amounts the customer owes the bank as a result of a disbursement of credit to the customer. However, the bank's right of set-off for future loans is usually defeated once it receives notice of the creation of a security right (or outright assignment) in favour of a third party. This may create difficulties for depositary banks and their commercial customers, which often must be in position to act very quickly in financing transactions affecting their bank accounts. The need to ensure that no notice of a third-party outright assignment or security right has been received before acting on the customer's instructions may interfere with the efficiency of these transactions. Uncertainties about the precise timing of the receipt of notice and the bank's disbursement of credit may also invite litigation between a third-party secured creditor or assignee and the bank. The concept of automatic control, combined with the priority awarded to the depositary bank, eliminates this source of risk and uncertainty.

145. The second approach to control also does not seem to have unreasonable adverse effects on the grantor. In the first place, the grantor must consent to the creation of a security right in favour of the depositary bank. Presumably the grantor will withhold this consent if the bank is not a source of financing. In addition, the priority rules associated with control can be altered by a subordination agreement in those situations where it would be more appropriate to ensure that first priority is given to another secured creditor. Assuming a competitive banking environment, banks will not unreasonably withhold their consent to subordination (or to a control agreement), since the grantor is always free to change its account to another institution.

146. While the concept of control is not, like registration in a general security rights registry, a transparent method of achieving third-party effectiveness, this lack of transparency does not, in general, put third parties in a significantly more disadvantageous position than they already occupy. As noted above, a depositary bank generally has the right under other law to set off any obligations owing to it by the grantor in preference to rights of the grantor's other creditors, whether secured or unsecured. As set-off is not a security right, it is not subject to any public registration requirement; nor is the bank obligated to disclose its rights of set-off to third parties. Thus, creditors in States that adopt the first approach cannot rely on a clean search of the registry since the bank may always assert a preference under its right of set-off; nor are transferees of funds paid out of the account

on the instructions of the grantor prejudiced since, as noted above, they generally take free of the security under both approaches.

147. States that have adopted the control approach usually provide that it is the exclusive method for achieving third-party effectiveness in this circumstance. However, this is an unnecessary limitation on flexibility, since the banking practice considerations underlying the adoption of control discussed above can be accommodated by giving a secured creditor with control priority over any secured creditor that registers its right, regardless of the respective order of occurrence of control and registration. While this approach makes registration a less effective method of achieving third-party effectiveness, the ability to register would still ensure that the security right will be effective against a grantor's judgment creditors and insolvency representative, since the special priority given to a secured creditor with control may be claimed only against other secured creditors and not as against all competing claimants.

148. As the approach that permits secured creditors, in particular depositary banks, to achieve third-party effectiveness of a security right by obtaining control conforms generally to the practical needs of banks and their commercial customers, the *Guide* recommends, in addition to registration in the general security rights registry, control as a privileged method for achieving third-party effectiveness of a security right in a right to payment of funds credited to a bank account (see recommendation 49).

3. *Third-party effectiveness of a security right in a right to receive the proceeds under an independent undertaking*

149. As previously explained (see chapter II on the creation of a security right, paras. 126-127), in many States, a security right may be created in the right to receive the proceeds of an independent undertaking, but not in the right to draw under the independent undertaking. This is the approach recommended in the *Guide* (see recommendation 27). By contrast, other States do not permit a security right to be created in the right to receive the proceeds of an independent undertaking. However, even among States that take the position recommended in the *Guide*, the particular character of the encumbered asset (the right to receive the proceeds) leads States to adopt different policies as to methods for achieving third-party effectiveness of such a security right.

150. In some States, such a security right may be made effective against third parties in more than one way. For example, the secured creditor may register a notice in the general security rights registry. Alternatively, in States that recognize the idea of control, the secured creditor may obtain control by agreement or automatically. However, in certain circumstances, it is impossible for the secured creditor to achieve third-party effectiveness by taking possession since the asset (the right to receive proceeds under an independent undertaking) is not a tangible asset (although the proceeds are tangible assets once they are paid).

151. In other States, control is the exclusive method recognized for achieving third-party effectiveness of a security right in a right to proceeds under an independent undertaking. Control, and, therefore, third-party effectiveness, exists automatically if the secured creditor is the issuer or other nominated person. If the secured creditor is a third party,

control requires the issuer or other nominated person to acknowledge the secured creditor's entitlement to receive the proceeds upon a proper draw by the beneficiary. Under this approach a secured creditor can obtain control and, therefore, third-party effectiveness only if the issuer consents to pay any properly drawn proceeds to the secured creditor. Two policies support the requirement that the issuer consent to make the payment. First, consent of the issuer is necessary in order to avoid forcing the issuer of the undertaking to deal with a third party. Second, this enables the issuer to ensure that the demand for payment has been duly made and that the beneficiary has agreed to the secured creditor's right to receive the proceeds.

152. As already noted (see para. 150 above), the very nature of the right to receive the proceeds of an independent undertaking makes it impossible to achieve third-party effectiveness of the security right in the right to receive the proceeds by taking possession of the instrument evidencing the right to receive the proceeds. However, this does not prevent a secured creditor from actually taking physical possession of the instrument (the independent undertaking itself). Even though this does not result in third-party effectiveness of the security right, possession of the instrument would give a practical level of protection to a secured creditor when the terms of the independent undertaking require the physical presentation of the instrument evidencing the independent undertaking to the issuer in order to make a draw. As the beneficiary could not make an effective draw without the secured creditor's cooperation, a secured creditor in possession could protect itself by requiring the beneficiary to obtain an acknowledgement of its rights from the issuer. That acknowledgement would enable the secured creditor to achieve control before it surrenders possession of the instrument.

153. The specific practices of the letter of credit and independent guarantee industry have an important bearing on the manner in which a security right may be made effective against third parties generally and especially against the issuer and nominated person. The issuer has to be protected against potential liability for payment to a secured creditor when presentation may not have been duly made or when conditions set out in the security agreement may disqualify the secured creditor from claiming payment once a draw has been properly made. For these reasons, the *Guide* recommends that control be the exclusive method by which a secured creditor may achieve third-party effectiveness of a security right in the right to receive the proceeds under an independent undertaking (see recommendation 50).

4. *Third-party effectiveness of a security right in a negotiable document or tangible assets covered by a negotiable document*

154. The central characteristic of a negotiable document (such as a bill of lading) is that it represents the tangible assets that are covered by it. The document, when properly endorsed, entitles its holder to claim possession of those assets upon delivery of the document. For this reason, in most States the creation of a security right in a negotiable document is normally considered to create a security right in the tangible assets covered by the negotiable document. It follows that, if the security right in the negotiable document is effective against third parties, a security right in the assets covered by the document is also effective against third parties during the period that the assets are covered by the document (see recommendation 52).

155. The tangible character of a negotiable document means that, where States have a general security rights registry, a security right in the document may be made effective against third parties either by registration in the general security rights registry or by transfer of possession of the document to the secured creditor during the period that the assets are covered by the document (see recommendation 51).

156. To facilitate the creation of security rights in assets covered by negotiable documents, the *Guide* recommends that as security right in such assets may be made effective against third parties either by registration in the general security rights registry or by transfer of possession of the document while the assets are covered by the document (see recommendations 51 and 52).

157. In practice, a secured creditor may have to relinquish possession of the document to enable the grantor to deal with the assets in the course of the grantor's business. Normally, this would result in the lapse of third-party effectiveness, unless the secured creditor had also achieved third-party effectiveness through registration. Some States give the secured creditor the benefit of a temporary period of automatic third-party effectiveness (such as 15 or 20 days) following relinquishment of possession of the document to enable the grantor to sell, exchange, load or unload or otherwise deal with the assets covered by the negotiable document. This automatic third-party effectiveness is not conditional on the secured creditor once again achieving third-party effectiveness before the expiry of the period. Consequently, the security right is effective against third-party rights that arise during the temporary period (but not afterwards) even if the security right is not otherwise made effective against third parties before the expiry of the period. This approach is consistent with the typically short-term nature of financing transactions based on assets covered by a negotiable document, which usually involve financing under an international sale of goods between a manufacturer or primary producer in one State and a wholesale buyer in another State. In the usual course of events, the secured creditor in this type of transaction will have been paid before the expiry of the period and will never retake possession of the negotiable document. This is the approach recommended in the *Guide* (see recommendation 53).

158. It is, however, important to note that in these States, in order for this automatic third-party effectiveness to exist, the security agreement must have been entered into (that is, the security right must be effective as between the parties). Consider the case where a security right in a negotiable document has been created by oral agreement and a transfer of possession of the document to the secured creditor. The transfer of possession is not simply a method for achieving third-party effectiveness. It is an essential element for the creation of a security right by oral agreement. However, where a security right is not created by a transfer of possession, some form of writing is necessary. Hence, should the secured creditor later relinquish possession temporarily, automatic third-party effectiveness will not result unless there is a writing sufficient to ensure that the security right continue to exist as between the parties (see chapter II on the creation of a security right, paras. 30-33, and recommendation 15).

C. Recommendations 29-53

Purpose

The purpose of provisions on the effectiveness of a security right against third parties is to create a foundation for the predictable, fair and efficient ordering of priority by:

(a) Requiring registration as a precondition for the effectiveness of a security right against third parties, except where exceptions and alternatives to registration are appropriate in light of countervailing commercial policy considerations; and

(b) Establishing a legal framework to create and support a simple, cost-efficient and effective public registry system for the registration of notices with respect to security rights.

1. General recommendations

Achieving third-party effectiveness

29. The law should provide that a security right is effective against third parties only if it is created and one of the methods for achieving third-party effectiveness referred to in recommendation 32, 34 or 35 has been followed.

Effectiveness against the grantor of a security right that is not effective against third parties

30. The law should provide that a security right that has been created is effective between the grantor and the secured creditor even if it is not effective against third parties.

Continued third-party effectiveness after a transfer of the encumbered asset

31. The law should provide that, after transfer of a right other than a security right in an encumbered asset, a security right in the encumbered asset that is effective against third parties at the time of the transfer continues to encumber the asset except as provided in recommendations 79-81 (chapter V on the priority of a security right), and remains effective against third parties except to the extent otherwise provided under recommendation 65.

General method for achieving third-party effectiveness: registration

32. The law should provide that a security right is effective against third parties if a notice with respect to the security right is registered in the general security rights registry referred to in recommendations 54-75 (chapter IV on the registry system).

33. The law should provide that registration of a notice does not create a security right and is not necessary for the creation of a security right.

Alternatives and exceptions to registration for achieving third-party effectiveness

34. The law should provide that:

(a) A security right may also be made effective against third parties by one of the following alternative methods:

(i) In tangible assets, by the secured creditor's possession, as provided in recommendation 37;

(ii) In movable assets, rights in which are subject to a specialized registration or title certificate system, by registration in the specialized registry or notation on the title certificate, as provided in recommendation 38;

(iii) In an attachment to a movable asset, rights in which are subject to a specialized registration or title certificate system, by registration in the specialized registry or notation on the title certificate, as provided in recommendation 42; and

(iv) In an attachment to immovable property, by registration in the immovable property registry, as provided in recommendation 43;

- (v) In a right to payment of funds credited to a bank account, by control, as provided in recommendation 49;
 - (vi) In tangible assets covered by a negotiable document, by the secured creditor's possession of the document, as provided in recommendations 51-53;
- (b) A security right is effective against third parties automatically:
- (i) In proceeds, if the security right in the original encumbered asset is effective against third parties, as provided in recommendations 39 and 40;
 - (ii) In an attachment to a movable asset, if the security right in the asset that becomes an attachment was effective against third parties before it became an attachment, as provided in recommendation 41;
 - (iii) In a mass or product, if the security right in processed or commingled assets was effective against third parties before they became part of the mass or product, as provided in recommendation 44; and
 - (iv) In movable assets, upon a change in the location of the asset or the grantor to this State, as provided in recommendation 45; and
- (c) A security right in a personal or property right that secures payment or other performance of a receivable, negotiable instrument or other intangible asset is effective against third parties, as provided in recommendation 48.

Method for achieving third-party effectiveness of a security right in a right to receive the proceeds under an independent undertaking

35. The law should provide that, except as provided in recommendation 48, a security right in a right to receive the proceeds under an independent undertaking may be made effective against third parties only by control, as provided in recommendation 50.

Different third-party effectiveness methods for different types of asset

36. The law should provide that different methods for achieving third-party effectiveness may be used for different types of encumbered asset, whether they are encumbered pursuant to the same security agreement or not.

Third-party effectiveness of a security right in a tangible asset by possession

37. The law should provide that a security right in a tangible asset may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor's possession.

Third-party effectiveness of a security right in a movable asset subject to a specialized registration or a title certificate system

38. The law should provide that a security right in a movable asset that is subject to registration in a specialized registry or notation on a title certificate under other law may be made effective against third parties by registration as provided in recommendation 32 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

Automatic third-party effectiveness of a security right in proceeds

39. The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset (including any proceeds of proceeds) is effective against third parties automatically when the proceeds arise, provided that the proceeds are described in a generic way in a registered notice or that the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

40. The law should provide that, if the proceeds are not described in the registered notice as provided in recommendation 39 and do not consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account, the security right in the proceeds continues to be effective against third parties for [a short period of time to be specified] days after the proceeds arise. If the security right in such proceeds is made effective against third parties by one of the methods referred to in recommendation 32 or 34 before the expiry of that time period, the security right in the proceeds continues to be effective against third parties thereafter.

Automatic third-party effectiveness of a security right in an attachment

41. The law should provide that, if a security right in a tangible asset is effective against third parties at the time when the asset becomes an attachment, the security right remains effective against third parties thereafter without any further action.

Third-party effectiveness of a security right in an attachment subject to a specialized registration or a title certificate system

42. The law should provide that a security right in an attachment to a movable asset that is subject to registration in a specialized registry or notation on a title certificate under other law may be made effective against third parties automatically as provided in recommendation 41 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

Third-party effectiveness of a security right in an attachment to immovable property

43. The law should provide that a security right in an attachment to immovable property may be made effective against third parties automatically as provided in recommendation 41 or by registration in the immovable property registry.

Automatic third-party effectiveness of a security right in a mass or product

44. The law should provide that, if a security right in a tangible asset is effective against third parties at the time when it becomes part of a mass or product, the security right that continues in the mass or product, as provided in recommendation 22 (chapter IV on the creation of a security right), is effective against third parties without any further action.

Continuity in third-party effectiveness upon change of location to this State

45. The law should provide that, if a security right in an encumbered asset is effective against third parties under the law of the State in which the encumbered asset or the grantor is located (whichever determines the applicable law under the conflict-of-laws provisions), and that location changes to this State, the security right continues to be effective against third parties under

the law of this State for [a short period of time to be specified] days after the change. If the requirements of the law of this State to make the security right effective against third parties are satisfied prior to the end of that period, the security right continues to be effective against third parties thereafter under the law of this State. For the purposes of any rule of this State in which time of registration or other method of achieving third-party effectiveness is relevant for determining priority, that time is the time when registration or third-party effectiveness was achieved under the law of the State in which the encumbered assets or the grantor were located before their location changed to this State.

Continuity in third-party effectiveness of a security right upon change of method of third-party effectiveness

46. The law should provide that third-party effectiveness of a security right is continuous notwithstanding a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

Lapse in third-party effectiveness or advance registration

47. The law should provide that, if a security right has been made effective against third parties and subsequently there is a period during which the security right is not effective against third parties, third-party effectiveness may be re-established. In such a case, third-party effectiveness takes effect from the time it is re-established. Similarly, if registration made before creation of a security right as provided in recommendation 67 expires as provided in recommendation 69 (chapter IV on the registry system), it may be re-established. In such a case, registration takes effect from the time when the new notice with respect to the security right is registered.

2. Asset-specific recommendations

Third-party effectiveness of a security right in a personal or property right that secures payment of a receivable, negotiable instrument or any other intangible asset

48. The law should provide that, if a security right in a receivable, negotiable instrument or any other intangible asset covered by this law is effective against third parties, such third-party effectiveness extends to any personal or property right that secures payment or other performance of the receivable, negotiable instrument or other intangible asset, without further action by either the grantor or the secured creditor. If the personal or property right is an independent undertaking, its third-party effectiveness automatically extends to the right to receive the proceeds under the independent undertaking (but, as provided in recommendation 25, subparagraph (b), of chapter II on the creation of a security right, the security right does not extend to the right to draw under the independent undertaking). This recommendation does not affect a right in immovable property that under other law is transferable separately from a receivable, negotiable instrument or other intangible asset that it may secure.

Third-party effectiveness of a security right in a right to payment of funds credited to a bank account

49. The law should provide that a security right in a right to payment of funds credited to a bank account may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor obtaining control with respect to the right to payment of funds credited to the bank account.

Third-party effectiveness of a security right in a right to receive the proceeds under an independent undertaking

50. The law should provide that, except as provided in recommendation 48, a security right in a right to receive the proceeds under an independent undertaking may be made effective against third parties only by the secured creditor obtaining control with respect to the right to receive the proceeds under the independent undertaking.

Third-party effectiveness of a security right in a negotiable document or a tangible asset covered by a negotiable document

51. The law should provide that a security right in a negotiable document may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor's possession of the document.

52. The law should provide that, if a security right in a negotiable document is effective against third parties, the corresponding security right in the asset covered by the document is also effective against third parties. During the period when a negotiable document covers an asset, a security right in the asset may be made effective against third parties by the secured creditor's possession of the document.

53. The law should provide that a security right in a negotiable document that was made effective against third parties by the secured creditor's possession of the document remains effective against third parties for [a short period of time to be specified] days after the negotiable document has been relinquished to the grantor or other person for the purpose of ultimate sale or exchange, loading or unloading, or otherwise dealing with the assets covered by the negotiable document.

IV. The registry system

A. General remarks

1. Introduction

1. The promotion of certainty and transparency of security rights in movable assets is a key objective of a modern secured transactions regime. Nothing is more central to the realization of this goal than the establishment of a general, notice-based, registry system (see recommendation 1, subparagraph (f)). For this reason, the *Guide* devotes an entire chapter to the optimal design, organization and operational details of such a registry system. Historically, actual possession was the basic mechanism for establishing security rights in movable assets. Over time, however, States developed other mechanisms for establishing and recording these rights. Some States relied on private record-keeping, for example, through the office of a notary, while other States developed public, asset-specific registry systems. As the number of transactions involving a dissociation of ownership and possession of movable assets (such as leases, loans and sales with a reservation of title) increased, and enterprises expanded and came to generate and make use of intangible assets, States were obliged to develop other registry mechanisms for publicizing security rights in movable assets.

2. The design and operational features of a registry system are driven largely by the purposes that the registry is intended to serve. There is no uniformity of such purposes among States. Some States, for example, seek to record title to those categories of movable assets that have sufficient durability and value to warrant the investment involved in establishing and operating the registry. Other States establish registries of more limited scope and for more limited purposes, for example, registries for security rights only, leaving title to be established by evidence that is not in the public record.

3. The general security rights registry recommended in the *Guide* focuses on recording of information about existing or potential security rights in movable assets. As such, it has three main purposes. First, registration offers secured creditors a general method for achieving third-party effectiveness of security rights in all types of movable asset, except the right to receive the proceeds under an independent undertaking. Second, registration provides third parties with an objective source of information about whether assets in a grantor's possession may be subject to a security right. Third, registration contributes to the efficient and fair ordering of priority by establishing an objectively verifiable temporal reference for applying priority rules based on the time of registration.

4. Although registration of a notice in the general security rights registry is the principal method recommended in the *Guide* for achieving third-party effectiveness of a security right, registration by itself does not result in third-party effectiveness and is not a prerequisite to the creation of a security right (see recommendations 13, 14 and 33). As explained in chapter III on the effectiveness of a security right against third-parties (see

paras. 35-36, third-party effectiveness is acquired only when both registration and the steps required for creation take place. However, it should be noted that, under the recommendations in this chapter, registration of a notice in the general security rights registry may take place before a security agreement is entered into or a security right is created (see recommendation 67).

5. Registration does not give what is known as “constructive notice” of the security right referred to in the notice. The doctrine of constructive notice is relevant only in a priority regime that permits a third party without actual knowledge of a security right to take the encumbered asset free of that security right. However, under the registration-based priority rules discussed in chapter V of the *Guide*, actual knowledge of the existence of a prior security right on the part of a competing claimant is irrelevant for determining priority (see recommendation 93).

6. The specific features of a modern general security rights registry are reviewed in the various sections of this chapter. Section A.2 addresses considerations relating to the structure and operation of such a registry. In sections A.3 and A.4, issues relating to the security, integrity and reliability of records in the registry are reviewed. Section A.5 discusses the required content of notices that may be filed in the registry. A number of details touching on advance registration, time of effectiveness, authority for registration, amendment and cancellation of registration are considered in sections A.6 to A.9. Specialized registries are considered briefly in section A.10. Chapter IV concludes, in section B, with a series of specific recommendations about the design and operation of a general security rights registry meant to ensure that registration and searching processes are simple, efficient and accessible. The question of the State in which registration should be made in transactions having a cross-border element is dealt with in chapter X on conflict of laws.

2. Operational framework of the registry

(a) General

7. Most States do not have a comprehensive centralized registry for security rights in all types of movable asset. Thus, the establishment of a general registry system for security rights in movable assets may constitute a significant change. Some States have registries that record title to and encumbrances against specific assets, such as ship, aircraft or motor vehicle registries. Other States have established multiple registries depending on the type of asset, the type of grantor or the type of creditor. Many States require that the specific documents creating the security right be registered or accompany an application for registration.

8. The general security rights registry recommended in the *Guide* is very different from the examples of existing registries just noted. First, it establishes a single, central registry for registering all security rights in all types of movable asset. Second, registry is effectuated by submitting a simple notice containing only the basic details of the security agreement; the registrant is not required to submit the underlying security documentation or otherwise provide evidence of its existence. This type of registry is thus an effort to address the inefficiencies, costs and delays caused by a diversity of approaches and multiplicity of registries.

(b) *Public education and training*

9. The novelty of a general security rights registry for many States suggests that States must take steps to ensure that the business and legal communities are educated about the existence of the registry and the substantive effects of registration well in advance of the entry into force of the law. It is equally essential to ensure that potential registry clients are given clear advice on the practical logistics of the registration and searching processes, for example, through the dissemination of guidelines and tutorials (ideally in both printed and electronic form) and the availability of in-person information and training sessions. Although the relevant governmental authority will usually take the lead in organizing public education and guidance, the expertise of the legal and business communities can be enlisted to assist. These initiatives need not be overly burdensome in view of the availability of implementation models and published materials in States that have already enacted similar reforms.

(c) *The concept of notice registration*

10. As already noted (see paras. 7-8 above), over the years States have developed many different types of registry system for movable assets. One of the most common types of registry system can be described as a title registration system. This type of registry system contemplates the registering of title and sometimes encumbrances and other transactions affecting title to specific movable assets such as ships. A title registry functions as a source of positive information about the current state of title to specific assets. In order to protect the integrity of the title record, the registrant is generally required to present the actual title transfer or security documents or a notarized or certified summary of those documents for scrutiny by the registrar.

11. A number of States have established what may be called a document registration system for security rights that, while not recording title to movable assets, serves to evidence the existence of specific security devices. Often, States have multiple registries of this type, depending on the asset, the grantor, the creditor or the type of security device involved. Sometimes, however, States have consolidated documentary registries of security rights. Whether the registries are multiple or single, the actual security documentation is submitted to and checked by a registrar who then issues a registration certificate that constitutes at least presumptive (if not conclusive) evidence of the existence of the security right.

12. In contrast to these systems, the general security rights registry recommended in the *Guide* is based upon the concept of notice registration. In a notice registration system, there is no requirement to register the underlying security documentation or even to tender it for scrutiny by the registrar. Instead, registration is effectuated by submitting a simple notice that provides only basic details about the security right to which it refers: (a) the identities of the parties; (b) a description of the encumbered assets; and (c) depending on the policy of each State, the maximum sum for which the security is granted and the requested duration of the registration (see recommendation 57).

13. Notice registration has many advantages. It greatly simplifies the registration process and minimizes the administrative and archival burden on the registry system.

In addition, registrants are relieved of the delay and cost of having to provide proof of the underlying security documentation. Moreover, the registry is relieved of the need to provide storage facilities for that documentation and to employ staff to scrutinize it. The risk of error and consequent liability of the registry is also greatly reduced. Furthermore, because the notice need contain only basic details, it is much easier to establish an electronic entry to record this data, rather than having to file the notice in a less time- and cost-efficient paper system. Finally, registration of a notice rather than a document is sufficient in view of the legal consequences of registration, that is, third-party effectiveness rather than creation of a security right (see chapter II on the creation of a security right, paras. 2-7, and chapter III on the effectiveness of a security right against third parties, paras. 6-8).

14. Registries based on a notice-registration concept exist in an increasing number of States and have also attracted considerable international support (see the Model Law on Secured Transactions of the European Bank for Reconstruction and Development, the Model Inter-American Law on Secured Transactions of the Organization of American States, the *Guide to Movable Registries* of the Asian Development Bank, the Convention on International Interests in Mobile Equipment and its related protocols and the annex to the United Nations Assignment Convention).¹ In keeping with these developments, this *Guide* recommends that States adopt this model of a general security rights registry (see recommendation 54).

(d) Prerequisites to registration

15. The formalities for and the prerequisites to registration vary from State to State. In many States, registration is intended to provide conclusive or presumptive evidence of a security right. Where this is the case, the registrar or some other public official has to scrutinize the contents of the security agreement and to confirm the accuracy and effect of the data in the registered notice.

16. As already noted (see para. 13 above), in a notice-based general security rights registry, there is no need for official verification or scrutiny of the underlying security documentation. Nor does such a registry system require advance scrutiny or approval of the content of the registered notice. Making official approval a prerequisite to registration would be inimical to the kind of speedy and inexpensive registration process needed to promote secured credit. The basic idea is to permit registration without further formalities (such as affidavits and notarization of documents) as long as the required registration fees are paid and the required information fields in the notice are completed (see recommendation 54, subparagraph (c)).

17. As registration of a notice of a security right is important to a secured creditor in connection with the third-party effectiveness and priority of its security right, the registrant will normally be the secured creditor or its nominee. However, since a notice-based registration system eliminates official scrutiny of the security documentation as a prerequisite to registration, there are typically no restrictions on who is permitted to make a registration (except as necessary for system-security and identification purposes; see para. 48 below). For the

¹See Introduction, footnotes 3-9.

same reason, consent by the grantor does not need to be established in a notice-based system at the time of registration or be part of the information registered. Although many States require the grantor's consent to the registration, the mere existence of the security agreement is usually considered to evidence consent, whether completed before or after the time of registration (see recommendation 54, subparagraph (d)).

(e) *Access to security documentation not in the public record*

18. Registration in a notice-based system is meant to alert third parties to the possible existence of such a right so that they may take steps to protect themselves against that risk. However, the registered notice does not contain all the information necessary for a third party to determine whether a security right actually exists and, if it does, what its status is or the terms of the security agreement. Thus, a third party has to request from the grantor or the secured creditor on the registry record access to the security documentation that does not appear on the record. For example, a prospective buyer or secured creditor can refuse to go ahead with an acquisition financing transaction unless a pre-existing registration is cancelled or unless the secured creditor identified in the registered notice undertakes to subordinate its right to that of the prospective buyer or secured creditor.

19. Some States oblige secured creditors to respond to requests for information from third parties concerning the current status of a security right referred to in a registered notice, including the current amount of the secured obligation that remains outstanding. This is usually required in order to assist unsecured creditors (including judgement creditors) in determining whether a security right actually exists and, if so, whether there is sufficient surplus value in the grantor's assets to warrant the expense of either bringing an enforcement action or attempting to seize and sell these assets. The right to demand this information is usually extended to all existing creditors as well as persons claiming a property right (for example, ownership or co-ownership) in the assets described in a registered notice. The assumption is that the grantor will not necessarily be willing to voluntarily to provide this information to its existing creditors or persons disputing its rights in the encumbered assets. Other States do not have such a requirement, but oblige judgement debtors to testify under oath as to their assets and the extent of any encumbrances on the assets. As this is largely a matter of debtor-creditor law within States, the *Guide* does not take a position on whether secured creditors should be obliged to respond to requests for information from third parties.

(f) *Protection of grantors against unauthorized registration*

20. As the prerequisites to registration in these systems are minimal, there is a risk that the system may contain registrations relating to a non-existent or no longer existing security right. Should this occur, a summary administrative procedure is typically made available to the grantor to compel the cancellation of an unauthorized or expired registration. Some States are concerned about potential fraud and abuse in these types of notice registration system in which registrations may be made with a minimum of formalities. In order to palliate this concern, some States also impose administrative penalties for unauthorized registrations or cancellations. The nature and extent of any safeguards adopted by a State depends on the judgement it makes about the extent of the risk of unauthorized and

fraudulent registrations relative to the costs that administering prescriptions of this nature are likely to impose. The *Guide* recommends the same approach (see recommendations 55, subparagraph (c), and 72, subparagraph (b)).

(g) *Centralized and consolidated registry record*

21. In some States, registry systems are decentralized and multiple. For example, it is often the case that land registry offices are organized on a regional, departmental or county basis. In addition, in many States there are multiple registries for security rights in movable assets, depending on the type of asset (for example, aircraft, ships, equipment, receivables or inventory), the grantor (for example, a natural or legal person) or the nature of the security right (for example, a combination of fixed and floating charges, an enterprise mortgage, a retention-of-title transaction or a non-possessory pledge). With the exception of asset-specific title registries for mobile assets such as ships and aircraft, multiple registries tended to develop as a result of an ad hoc, piecemeal recognition of individual non-possessory security devices in movable assets.

22. In States that have come to adopt a functional concept of security rights in movable assets, there is a strong incentive both to centralize and to consolidate the registry system. That is, once the substantive rules governing security rights are brought together under a unitary regulatory regime, it is possible and most efficient to consolidate all registrations in a single registry record, regardless of the type of asset, the nature of the grantor as a legal or a natural person or the nature of the security right. In addition, even among States that maintain a formal diversity of acquisition financing rights (what the *Guide* calls a non-unitary approach to acquisition financing ; see chapter IX on acquisition financing) it is still possible and efficient to provide for the registration of all these rights in the general security rights registry.

23. Ideally, the record should be maintained in electronic form in a single centralized database for each State. In States in which separate regional or district records are maintained, complex rules are needed to determine the appropriate registration venue and to deal with the consequences of a relocation of the assets or the grantor. While it is possible to imagine the physical integration of decentralized, multiple documentary registries, the goals of efficiency, accessibility and transparency in the registration system are more fully achieved through consolidation and centralization of an electronic-form registry of the type recommended in the *Guide* (see recommendation 54, subparagraph (e)).

24. The establishment of a centralized registry database may engender a concern about equality of access for users in remote locations. However, modern communication technology supports the rapid onward transmission to the central registry of notices that are submitted at a branch office. That is, by establishing records in electronic form, it is possible to use local registry offices as points of access to a centrally maintained registry. This is an important advantage of electronic registries. In addition, electronic registries make it possible to establish mechanisms for online access to the record. As long as appropriate protocols for registration and searching are in place, this means that access to the registry will be possible from any location where Internet or other electronic connections are available. Finally, even if the registry is maintained in electronic form, it is still possible to permit registration in paper form with the information in the paper form then entered

by registry staff into the computerized record. The manual transcription of data from paper to electronic form may, however, increase the risk of error and liability of the registry. It will also necessarily increase the cost of registration since registry personnel will be required to make the transcriptions. To the extent feasible, therefore, the registry should be designed so that those that wish to register notices have the responsibility for directly entering them electronically in a prescribed registration template. This is the approach recommended in the *Guide* (see recommendation 54, subparagraphs (e) and (j)).

(h) *Public access*

25. One of the central objectives of any registry system is to enhance legal certainty about entitlements to assets. A well-functioning registry enables interested third parties, including existing and future creditors, as well as buyers of encumbered assets, to find out whether a security right exists in a person's assets. With this information, they can take steps to protect themselves against the priority risk this may pose to their potential rights or the impact it may have on their existing rights.

26. In order to achieve this objective, a registry record must normally be accessible by the public. States take different views about the appropriate balance between public access by interested third parties and protecting the confidentiality of the relationship between a grantor and a secured creditor. The policy choices relate to two issues: (a) whether restrictions should be imposed on who is entitled to search the registry; and (b) what criteria may be used to search the registry. Each of these two issues is considered in detail below.

(i) *Entitlement to search the registry*

27. In a few States, access to the registry record for searching is restricted to persons that can demonstrate a legitimate reason. What constitutes a legitimate reason varies widely from State to State. Sometimes the criteria are so narrowly drawn that open competition for credit can be compromised. Moreover, the imposition of criteria for access means that someone has to exercise judgement as to the legitimacy of the search, a procedural requirement that impedes the efficiency and increases the administrative cost of conducting a search.

28. In States that have adopted a general notice-based security rights registry, public access is usually unqualified. Permitting full public access does not compromise the confidentiality of the relationship between a grantor and a secured creditor. Confidentiality is protected because only limited information about the parties' affairs appears in the registered notice. That is, the notice typically indicates only the names of the parties (or the name of an agent of the secured creditor), a description of the encumbered assets, the duration of registration (and, in some States, the maximum amount for which the security right encumbers the asset, although not the actual amount). Since the *Guide* recommends adoption of a notice-based general security rights registry, it also recommends that, in the interests of avoiding unnecessary cost and delay, searchers should not be required to establish a legitimate reason, or indeed any reason, for initiating a search. In sum, the registry should be fully public (see recommendation 54, subparagraphs (f) and (g)).

(ii) *Searching by reference to the grantor or to the secured creditor*

29. As explained in the next subsection, the legal function of a general security rights registry requires the record to be organized to permit searching by the identity of the grantor as opposed to that of the secured creditor. As a practical matter, however, the quantity and content of notices filed by a particular secured creditor have a potential market value as a source of that person's customer lists for companies seeking to market related financial or other products. To enhance revenues, a few States therefore permit searching according to the identity of the secured creditor as well as that of the grantor, but most States do not. The policy concern behind the majority approach is that, since the ability to retrieve and sell this kind of information is not relevant to the mission of the registry, permitting searches according to the identity of the secured creditor might violate commercial expectations of confidentiality and damage public trust and confidence in the system. For these same reasons, the *Guide* recommends that the name or other identifier of the grantor be the only publicly available search criterion (see recommendation 54, subparagraph (h)). However, States may wish to establish search functionality according to the name of the secured creditor for internal administrative use (as opposed to public searching) as it facilitates the processing of amendments to multiple registered notices in cases where the secured creditor changes its business name.

30. In the interest of efficiency, some States explicitly allow a registrant to identify the secured creditor in the registered notice according to the name of a trustee, agent or other representative. This approach facilitates, for example, syndicated loan arrangements since only the lead bank or its nominee need be identified as the secured creditor of record. The rights of third parties are not prejudiced so long as the person identified as the secured creditor on the notice is in fact authorized to act on behalf of the actual secured creditor in any communication or dispute connected to the security right to which the registration relates. After all, the key reason for requiring the secured creditor to be identified in a registered notice is to enable searchers to find out whom to contact in order to obtain further information about possible security rights encumbering identified assets of the grantor. This approach also has the incidental benefit of further addressing the concern about protecting confidential business information of secured creditors. As it facilitates secured financing without prejudicing the grantor or third parties, the *Guide* recommends this approach (see recommendation 57, subparagraph (a)).

(i) *Grantor indexing as compared with asset indexing*

31. The primary interest of a competing claimant is to determine whether any particular asset of a grantor may be encumbered. In theory, therefore, a registry could be organized so that searchers could access this information either by entering the name or other identifier of the grantor or a reference to the encumbered asset. Traditionally, land registries are most commonly organized and indexed by reference to the asset (a particular parcel of land) rather than by reference to the owner. Encumbrances on land are, consequently, also indexed by reference to the asset rather than by reference to the grantor. Similarly, as noted above, in some States there are also specialized movable asset registries (for example, for ships, aircraft and, occasionally, for motor vehicles) for recording title, as well as security rights and other encumbrances. These registries, too, are typically organized on the basis of an asset-indexing system. However, when it comes to registries designed to

record only security rights in movable assets, registrations are normally entered, indexed and searched solely by reference to the identity of the grantor of the security right rather than by reference to the asset.

32. Grantor-based indexing is so widely popular in the context of a general security rights registry because it greatly simplifies and facilitates the registration process. Secured creditors can achieve third-party effectiveness of a security right even in all of a grantor's existing and future movable assets through a single registration. They need not worry about updating the record every time the grantor acquires a new asset, as long as the asset fits into the description in the notice. Consequently, the *Guide* recommends that the primary indexing mechanism for notices registered in the general security rights registry should be the identity of the grantor (see recommendation 54, subparagraph (h)).

33. Grantor-based indexing does, however, have one important drawback. If the encumbered assets become the object of unauthorized successive transfers, prospective secured creditors and buyers cannot protect themselves by conducting a search according to the name of the immediate apparent owner. Because the system is indexed by reference to the grantor, the search will not disclose a security right granted by any of the apparent owner's predecessors in title. An example illustrates the problem. Grantor A may, without the permission or knowledge of secured creditor B, sell assets encumbered by a security right to buyer C that, in turn, may propose to sell or grant a security right in them to D. Assuming that D is unaware that C acquired the asset from the original grantor, D will search the registry using only the name of C. Because the notice was indexed in the name of the original grantor (A), D's search will not disclose the registration. Consequently, in a grantor-indexed registry system, in order to discover the full picture of security rights that may affect a person's assets, a prospective secured creditor or buyer will have to obtain documentation from sources other than the public record in order to determine the chain of title to these assets.

34. To overcome this problem, some States organize their general security rights registries to provide for supplementary asset-based indexing and searching in the case of high-value, durable assets for which there is a resale market and which have a reliable universal numerical or other identifier that can be used as a search criterion. The most common of these supplementary asset-based indices deal with motor vehicles, where registrations are also indexed according to the manufacturer's serial identification number.

35. Serial number identification, however, also has its drawbacks, since it imposes an additional registration burden and risk on secured creditors and limits the feasibility of achieving third-party effectiveness with respect to future assets and bulk assets such as inventory. Where the encumbered asset constitutes either capital equipment or consumer goods in the hands of the grantor, it is usually treated as a discrete asset by both the grantor and the secured creditor. Thus, the administrative inconvenience of also having to enter a specific numerical identifier in the registered notice will not be unduly burdensome. However, if the encumbered assets are instead held by the grantor as inventory intended for resale or lease, requiring a serial number description would impose an unworkable registration burden on secured creditors, since they would have to register amendments to record the serial number of each new item of inventory as it is acquired by the grantor. In any event, serial number identification of inventory is normally unnecessary to protect buyers and lessees. Most often they will acquire the encumbered assets in the ordinary course of the seller's business, in which case they take the assets free of any

security rights created by the seller or by any predecessor in title to the immediate seller (see recommendations 80-82). For these reasons, States that provide for a serial-number field in the record of a general security rights registry typically limit the mandatory requirement for serial number identification to cases where the serially numbered assets are not held as inventory (see also paras. 85 and 115 below).

36. In addition, as noted above, from a cost-benefit perspective the scope of serial number registration should be limited to relatively high-value, durable assets for which there is an existing resale market since these are the only categories of encumbered assets where concerns about prejudice to remote parties are likely to pose a practical problem. For asset-based registration and searching to be workable for these types of asset, the assets also must be of a kind for which a reliable and universally recognized numerical or similar unique identifier exists.

(j) Registration and searching fees

37. The fundamental logic of a general security immovable assets registry system is to enhance transparency and certainty regarding security rights in movable assets. For this reason, modern registry systems are designed so as to encourage registrants and searchers to use the system. It is, therefore, critical for fees to be set at a level that facilitates access, while still enabling the system to recover its capital and operational costs within a reasonable period of time. Excessive registration and searching fees designed to raise revenue rather than support the cost of the system are tantamount to a tax (ultimately borne by borrowers) that discourages access to and use of the system. Consequently, the *Guide* recommends that fees for using the registry should be no greater than what is required for the registry to be self-financing (see recommendation 54, subparagraph *(i)*).

(k) Modes of access to the registry

38. Traditionally, registration records had to be kept in paper form. However, the advent of digital storage has facilitated the adoption of computerized databases, greatly reducing the administrative and archival burden on the registry.

39. A computerized record has many advantages over a paper-based system. Most obviously, electronic archives take less space and are easier to search. In addition, most modern systems authorize electronic submission of registrations and the electronic submission and retrieval of search requests and search results, thereby facilitating direct client access. Most modern security rights registries also permit direct electronic access to amend or cancel a registration. Direct client access significantly reduces the costs of operation and maintenance of the system. It also enhances the efficiency of the registration process for clients by putting direct control over the timing of registration into the hands of the registrant. In particular, direct electronic access eliminates any time lags between submission of a notice to the registrar and the actual entry into the database of the information contained in the notice.

40. In some States with a general security rights registry, electronic access (either from a client's premises or from a branch office of the registry) is the only available mode of

access for both registration and searching. As the data to be registered is submitted in electronic form, no paper record is ever generated. A fully electronic system of this kind places the responsibility for accurate data entry directly on registrants. As a result, staffing and operational costs of the registry are minimized and the risk of registry personnel making an error in transcribing documents is eliminated. Other States provide for electronic registration and searching but also give clients the option of submitting a paper registration or search request in person, by fax or verbally by telephone. However, even in these States electronic submission is by far the most prevalent mode of data submission, used in practice for the vast majority of registrations.

41. The *Guide* recommends that, to the extent possible, States establish a general security rights registry that is computerized and that permits direct electronic access by registry clientele (see recommendation 54, subparagraph (j)). Nonetheless, given the practical considerations involved in establishing an electronic registry, the *Guide* also recommends that multiple modes of access be made available to registry clientele at least in the early stages of implementation in order to reassure users who are unfamiliar with the system. Finally, to facilitate use, the *Guide* recommends that the registry be organized to provide for multiple points of access for both electronic and paper or verbal submission of notices and search requests (see recommendation 54, subparagraph (k)).

(l) *Service hours*

42. Recognizing the importance of public access, most States operate their registries according to a reliable and consistent schedule, coordinating opening hours with the needs of their clients. Depending on these needs, this may well require the registry to open prior to the beginning of and to remain open after the close of the regular business day. If the system supports direct electronic access, the days and hours of operation are not a practical concern. It can be made accessible on a continuous basis 24 hours a day, 7 days a week. For this reason, the *Guide* recommends that the registry should be designed so as to be accessible continuously except for brief periods to undertake routine, scheduled maintenance (see recommendation 54, subparagraph (l)).

(m) *Optimal use of electronic technology*

43. The benefits of a general security rights registry that supports a computerized registry record and direct electronic access have already been discussed. However, the extent of computerization that is possible may vary in different States depending on the extent of start-up capital available, access to the right expertise, the level of computer literacy of potential users, the reliability of the local communication infrastructure and the probability that expected revenues will be sufficient to recover the capital costs of construction within a reasonable period. Not all States may be able to move immediately to a fully computerized registry. Nonetheless, even where States continue to use paper-based registries the overall objective is the same, that is, to make the registration and searching process as simple, transparent, efficient, inexpensive and accessible as possible. Consistent with its general approach to the use of electronic technology (see recommendations 11 and 12), the *Guide* recommends that, as quickly as is feasible, States establish a general security rights registry that

is computerized and that permits direct electronic access (see recommendation 54, subparagraph (j)).

(n) *Language of the registry*

44. As noted above, in a modern security rights registry, only notices relating to security agreements are recorded. Neither the security agreement itself nor a summary of its content is registered. As a result, the language of the security agreement will have no direct bearing on the language of records in the registry (for the language of the security agreement, see chapter II on the creation of a security right, para. 16; for the language of notices in the context of enforcement, see chapter VIII on the enforcement of a security right, paras. 47 and 70). Given the way in which a modern general security rights registry is organized and indexed to facilitate searching by reference to the grantor's name or other identifier, registry records will be written in the language of the registry. That is, although the security agreement may be in any language agreed upon by the parties, the information about the name of the grantor or other identifiers contained in the registry record will be in the language of the registry. The only exception to this rule would be where the official name of a grantor, for example, a foreign business enterprise, is itself in a foreign language. Unless other law provides that businesses must have an official name in the national language, here the registry record will contain information in a foreign language. Where there is no such requirement, some other difficulties may arise where a grantor's official name is in an alphabet that is different from the alphabet of the language of the registry. In such cases, States will have to provide for regulations that enable the grantor identifier to be rendered into a name or spelling that enables effective searching.

45. Similar considerations apply to the language by which the encumbered assets are described. Modern general security rights registries are often computerized. Parties are permitted to tick off a box that gives a generic description of the encumbered assets, but usually also need to give a narrative description in order to identify the encumbered assets sufficiently. Here also, the function of the registry (to provide searchers with access to information that allows them to determine what assets of a grantor are actually encumbered with a security right) favours requiring that the description of those assets be in the language of the registry.

46. A number of States have more than one official language. In these States, registries are typically designed to accommodate registration in all official languages. To ensure that information is available to all searchers, some States require parties to make their registration in all official languages. Other States permit filing in one language only, but require the administrator of the registry to prepare and register duplicate copies in all official languages. Both of these approaches are costly and open the door to errors in, for example, the grantor's identifier or to differences between language versions in the description of the encumbered assets. As a consequence, in many States with multiple official languages, any one of which may be used to register a security right, the registration need be made in one language only. Nonetheless, in these States the registration and search interface is available in all official languages of the registry. The *Guide* makes no recommendation on the language of the notice, leaving this matter to other law. States will have to consider ways to address this matter so as to ensure that the notice can be reasonably expected to be understood by the grantor and third parties.

3. Security and integrity of the registry record

(a) State responsibility for the system

47. Over the years, States have adopted different approaches to the management and operation of registry systems. In some States, the service is provided by a Government department or a publicly owned corporation. In other States, this responsibility is delegated to a particular profession, such as notaries. In still other States, day-to-day operations are provided through a private entity, especially where such an entity is able to provide a more cost-efficient service. However, with the sole exception of States where no public recording mechanism exists and informal, privately-run record offices fill the gap, the State inevitably retains the responsibility to ensure that the registry is operated in accordance with the appropriate legal framework. This is the approach recommended in the *Guide* (see recommendation 55, subparagraph (a)).

(b) Record of the identity of the registrant

48. Some States require registrants to supply proof of their identity. The main reason for this approach is to ensure the legitimate use of the registry. The disadvantage is that it is likely to increase the time and cost of registration. In other States, although the registry may require a registrant to state its identity, it does not require verification of identity as a precondition for registering a notice (other than as necessary for the purposes of processing payment of registration fees). In States where there are concerns about unauthorized or malicious registrations, the registry may need to require at least minimal proof of identity (as to the rights of the grantor to compel appropriate cancellations or amendments of registrations, see recommendation 72). This need not pose an excessive administrative burden if the identification procedure is built into the payment process. Moreover, since most registrants will be repeat users, a permanent secure access code can be assigned when the account with the registry is opened, eliminating the need to repeat the identification procedures for subsequent registrations. This is the approach recommended in the *Guide* (see recommendations 54, subparagraph (d), and 55, subparagraph (b)).

(c) Grantor's entitlement to a copy of the registered notice

49. Because a registered notice indicates that the grantor may have created or may intend to create a security right in its assets and therefore may affect the grantor's ability to receive further secured credit, most States provide that a grantor named in a registered notice is entitled to receive a copy of the registration and of any amendments to the notice made by the secured creditor. This enables the grantor to verify the accuracy of the data on the notice and, in the case of inaccurate, unauthorized or malicious registrations, to exercise its right to compel the amendment or cancellation of the registration (see recommendations 72 and 74).

50. States differ as to who should bear the obligation to forward a copy of the registered notice to the grantor. In order to provide optimal protection against the risk of unauthorized registration, some States place this burden on the registry system itself. In this way, when the registration is fraudulent the purported grantor will discover the

fraud, a discovery unlikely to occur if the obligation to forward a copy of the notice were placed on the purported secured creditor. However, this advantage must be weighed against the additional costs and risks such a burden would impose on the registry system. In the absence of evidence that unauthorized registrations are posing a serious and substantial threat to the integrity of the system in a specific State, a cost-benefit analysis supports placing the obligation on the secured creditor.

51. Moreover, because in most cases registrations are made in good faith and are accurate, requiring the secured creditor to forward a copy of the registered notice to the grantor need not be a condition of the effectiveness of the registration and could even complicate or delay such effectiveness. This is because a failure to send a notice to the grantor in no way affects the rights of third parties consulting the registry. For this reason, most States provide that the failure of the secured creditor to meet this obligation results only in nominal administrative penalties and the award of damages for any actual harm caused to the grantor. Given the general approach of the *Guide* to keeping the administrative costs of the registry as low as possible, it recommends that responsibility for furnishing a copy of the notice to the grantor be placed upon the secured creditor (see recommendation 55, subparagraph (c)).

(d) Secured creditor's entitlement to a copy of changes to registration

52. In most States that have established a modern general security rights registry, a registered notice may be cancelled or amended by the secured creditor at any time in the same way as any other type of registration (see recommendation 73). In addition, most States enable the grantor to compel cancellation or amendment of a registration through summary judicial or administrative proceedings (see recommendation 72, subparagraph (b)). To enable the secured creditor to check the legitimacy of a cancellation or amendment, the registry is normally obligated promptly to forward a copy of any changes to a registered notice to the person identified as the secured creditor in the notice. This should not involve excessive cost or risk for the registry system, since an efficient mode of electronic communication (such as electronic mail) can be agreed to when the account of the secured creditor in the registry is initially opened. Moreover, if the system is electronic, it can be programmed to forward automatically a copy of any amendments to a specified electronic mail account without the need for any human intervention. This is the approach recommended in the *Guide* (see recommendation 55, subparagraph (d)).

(e) Prompt confirmation of registration

53. It is in the interest of all parties to receive prompt confirmation that a registration has been made. For example, before advancing funds under a security agreement, a secured creditor will typically want to receive some assurance that its notice has been entered into the registry record and that the information has been accurately recorded. In addition, to ensure its priority against other potential secured creditors, a secured creditor will often register a notice relating to a security agreement that has not yet been entered into with the grantor. Consequently, modern electronic registries are designed to enable the registrant to obtain a printed or electronic record of the registration as soon as the data is entered. In a paper-based registry, there will inevitably be some time lag between the submission of

the notice and confirmation that it has been entered into the record, but every effort should be made to reduce the delay to a minimum. This is the approach recommended in the *Guide* (see recommendation 55, subparagraph (e)).

(f) *Data integrity and preservation*

54. Any registry system, whether paper-based or electronic, is at risk of destruction through unforeseen events. Usually, it is very difficult to reconstruct a paper-based registry if the physical records are damaged or destroyed (for example, by flood or fire). Not many States have the resources to be able to keep duplicate papers archived at a separate location. Moreover, because copies must be filed and indexed manually, there is an ever-present risk of human error. Where a paper registry is archived electronically, however, or where the entire registry is itself kept electronically, it is much easier to ensure the preservation of data in the registry. States with electronic registries typically maintain a backup copy of the records of the registry on a separate server in a different location. This backup copy is normally updated by a separate procedure on a nightly basis so that it can be reconstructed in the event of system malfunction or physical destruction. In order to ensure that the integrity of the registry records is preserved in a cost-effective manner, the *Guide* recommends that electronic registries be systematically backed up (see recommendation 55, subparagraph (f)).

4. *Responsibility for loss or damage*

55. As noted above (see para. 47), a general security rights registry is publicly administered in the sense that, while the maintenance of the system may be contracted out to the private sector, the ultimate supervisory responsibility is vested in a publicly appointed registrar and public servants under the registrar's supervision. For this reason, most States have detailed rules setting out the conditions under which they assume legal responsibility for loss or damage caused by staff or system errors and the extent of responsibility they are prepared to assume. In theory, whatever the type of registry that is adopted, staff or system error could cause loss in three situations.

56. The first situation is where an employee or representative of the registry is alleged to have given incorrect or misleading verbal advice or information. Some States exclude liability altogether in this situation. In States where recourse against the registry is permitted, direction is usually given on the standard of care required. In some States, the employee's conduct has to satisfy the standard of liability imposed by the general law governing fault-based obligations. Other States set a stricter standard, requiring the person that was allegedly misled to establish bad faith.

57. The second potential area of liability is for loss caused by an error or omission in the information entered into the record of the registry. Any errors in the information submitted by registrants will be their responsibility. The only error that can occur on the part of the registry is if the information submitted by a registrant is incorrectly entered into the registry database. Here the key question is who is responsible for entering the data submitted by a registrant into the database.

58. If the registration data is initially submitted by registrants to the registry staff (whether by fax, paper or telephone), the registry staff will need to enter it into the database and therefore will be responsible for any inaccuracies in the transcription process. In this situation, regimes usually give a remedy for loss or damage caused by a failure on the part of registry staff to enter the information into the registry database or by a failure to enter it accurately.

59. However, if the notice is submitted electronically, modern systems typically provide a standardized electronic form that enables the data supplied by the registrant to be entered automatically into the registry database (subject only to electronic edits for compulsory fields) without any scrutiny or intervention or further action by registry staff. In these systems, it is the registrant that bears the risk of error since the error necessarily must be attributable to the data supplied by the registrant. Even if the problem could conceivably have been caused by a malfunction in the system, States typically exclude liability for any alleged failure of the system to effectuate the registration or to effectuate it correctly. The absence of a paper version (or faxed version or written record of an oral submission) of the registered notice makes an allegation of system malfunction impossible to prove.

60. If a member of the registry staff transcribes the information submitted by a registrant inaccurately, the person normally entitled to compensation will be the third-party searcher that suffers loss as a result of reliance on the misleading information in the registered notice. The position is different if the error consists in a failure of the registry staff to enter the information on the paper notice into the system altogether. The *Guide* recommends that registration be treated as effective only upon entry of the registration data into the database so as to be searchable by third parties (see recommendation 70). It follows that where a notice submitted by a registrant to the registry staff is never entered into the system, it never becomes legally effective and the person potentially suffering the loss will be the secured creditor whose security right was never legally made effective against third parties.

61. The third situation of potential liability arises where the registry issues a search result that does not accurately reflect the information in the registry database. In this situation, some States recognize liability for loss caused by an error or omission in a search result caused by the fault of registry staff. However, issues of proof preclude liability where the claimant alleges an error in a search result viewed electronically or printed at the client's own premises.

62. Not all States accept unqualified liability for errors committed by registry personnel. Some States rely on the principle of sovereign immunity to shield the registry from liability altogether. Other States accept liability but establish an upper limit on the amount of potential recovery. States that admit liability usually also establish procedural qualifications, requiring applicants to follow explicit guidelines for making and proving a claim and imposing a prescription period for launching a claim.

63. Some States have established special compensation funds to cover any loss where liability is established. Where a special compensation fund is established to protect the registry, a small amount is usually added to the registration fee and paid into the fund to cover payment of any successful liability claims. Where the registry subscribes to a private insurance plan designed to cover such losses, the small additional amount added to the registration fee is used to cover the insurance premium.

64. The *Guide* does not seek to discriminate among the various approaches discussed above, treating this as a variable policy matter to be addressed by each State. The main point is that, whichever approach is adopted, enacting States should provide clear rules governing the allocation of responsibility for loss or damage caused by an error in the administration or operation of the registry (see recommendation 56).

5. *Required content of the registered notice*

65. The general security rights registry system recommended in the *Guide* is based on the concept of notice registration. States that have adopted this system invariably require the following basic information to be set out in the registered notice: (a) the name or other identifier of the grantor and the grantor's address; (b) the name or other identifier of the secured creditor and its address; and (c) a description of the encumbered assets (see recommendation 57). In States that do not impose a pre-set statutory term on the duration of registration, the registrant is also required to specify the desired term of the registration in the notice. In addition, some States require the registrant to set out the maximum monetary amount for which the security right covered by the notice may be enforced (on both points, see recommendation 57). All of these content requirements are discussed in detail below.

(a) *Grantor information*

(i) *Effect of error in the grantor's identifier on the effectiveness of registration*

66. In a modern general security rights registry, notices are indexed and searched by reference to the grantor's name or other identifier (see recommendation 54, subparagraph (h)). Consequently, a reference to the grantor's identifier in the notice is an essential component of a valid registration. The impact of an error in the grantor's identifier on the legal effectiveness of a registered notice depends on the organizational logic of the particular registry system. Some electronic records are programmed to retrieve only exact matches between the identifier entered by the searcher and the identifiers in the database. In such systems, any error will render the notice irretrievable by searchers using the grantor's correct identifier. For this reason, the purported registration is null, with the result that the security right is ineffective against third parties.

67. Some States have put in place a more sophisticated search algorithm. In these States, registry records are organized and indexed so as to enable a searcher that enters the correct identifier to retrieve notices in which the grantor's identifier is a close but not identical match to the correct identifier. Similarly, if the searcher were to enter an incorrect identifier, a correct identifier that is a close but not identical match would also be retrieved. In States that have adopted this more sophisticated search algorithm, the validity of some otherwise defective registrations is preserved notwithstanding the error so long as a search using the correct identifier would still disclose the registered notice albeit as an inexact match. This is the approach recommended in the *Guide* (see recommendation 58). However, this type of system works only if the search logic is carefully designed to limit the number of close matches that the search turns up. If searchers entering the correct identifier are confronted with a search result that yields an excessive number of notices

containing close matches, the burden of the initial registrant's error would be unfairly shifted onto the searcher, who might then have to undertake a large number of additional inquiries to determine which, if any, of these close matches refers to the grantor in question.

(ii) *Correct identifier for natural persons*

68. As an error in the grantor's identifier may invalidate a registration, States usually take great care to establish clear legal rules on what constitutes a correct identifier. The grantor's name is the most common criterion. However, a State may not have a universal rule on what constitutes a natural person's correct legal name and the name used in everyday business or social life may differ from that which appears on the grantor's official documents. Moreover, name changes may have occurred since birth as a consequence of a change in marital status or other deliberate choice. Consequently, the regulations or administrative rules governing the operation of the registry usually need to provide explicit guidance on what official documentary sources of the grantor's name can be relied on by registrants and searchers.

69. What documents will be considered authoritative for this purpose depends on the availability and reliability of the official documents issued by each State. In order to accommodate grantors that do not possess the relevant first-order official document and grantors that are not residents or nationals of a particular State, States typically provide a hierarchy of alternative references.

70. There is no universal formula for setting this hierarchy, since so much depends on the resources available in each State for providing reliable identifiers for natural persons as well as local naming conventions. That said, the following paragraphs illustrate how States might implement the approach recommended in the *Guide* (see recommendation 59):

(a) If the grantor was born in the enacting State and the grantor's birth was registered with a Government agency, the name of the grantor is the name stated in the grantor's birth certificate;

(b) If the grantor was born in the enacting State but the grantor's birth was not registered, the name of the grantor is:

(i) The name stated in a passport issued to the grantor by the Government of the enacting State;

(ii) If the grantor does not have a passport, the name stated in a current national identity card or, failing that, a current social insurance card issued to the grantor by the Government of the enacting State;

(iii) If the grantor does not have a current passport, national identity card or social insurance card, the name stated in a passport issued to the grantor by the Government of the State where the grantor habitually resides;

(c) If the grantor was not born in the enacting State but is a citizen of the enacting State, the name of the grantor is the name that appears in the grantor's certificate of citizenship;

(d) If the grantor was not born in the enacting State and is not a citizen, the name of the grantor is:

- (i) The name stated in a current visa issued to the grantor by the Government of the enacting State;
- (ii) If the grantor does not have a current visa, the name stated in a current passport issued to the grantor by the Government of the State where the grantor habitually resides;
- (iii) If the grantor does not have a current visa or a current passport, the name stated in the birth certificate or equivalent document issued to the grantor by the Government agency responsible for the registration of births in the State where the grantor was born;

(e) In a case not falling within the preceding rules, the name of the grantor is the name stated in a current motor vehicle operator's licence or vehicle registration certificate or other official document issued to the grantor by the enacting State; and

(f) If the grantor's name as otherwise determined by these rules has legally changed in accordance with the law of the State of habitual residence of the grantor, including a change of name by marriage, the name of the grantor is the new legal name if the name change has occurred at the time the security is created.

71. If a search reveals that more than one grantor shares the same name, the grantor's address will often resolve the identity issue for searchers. In States where many individuals share the same name, it may be useful to require supplementary information, such as the grantor's birth date. If a State has adopted a numerical identifier for its citizens, this can also be used, subject to the enacting State's privacy and security policies and subject to prescribing an alternative identifier for grantors that are not nationals. The *Guide* recommends that, wherever a State requires additional or supplementary identifiers, the law should explain the consequences to the validity of the registration of providing less than all of them correctly (see recommendation 59).

(iii) Correct identifier for legal persons

72. For corporate grantors and other legal persons, the grantor's identifier for the purposes of effective registration and searching is normally the name that appears in the document constituting the entity. This name can usually be verified by consulting the public record of corporate and commercial entities maintained by each State. Problems with common identifiers are unlikely to occur, since business names generally have to be unique to be accepted by a company or commercial registry. If the information in this record and in the security rights registry is stored in electronic form, it may be possible to provide a common gateway to both databases to simplify the verification process. The *Guide* recommends this approach (see recommendation 60).

(iv) Distinction between natural and legal persons

73. A registrant usually will be required to indicate whether the grantor is an individual or a natural person on the one hand, or a legal person on the other hand. Although the terminology may vary, the basic dividing line is the same. Accurate designation is essential because the two categories of grantors are usually stored in separate searchable fields or books within the registry record. A search in the legal person's record will not disclose

a security right registered against an individual grantor and the converse is also true. Ensuring accuracy is especially important where an individual, say, John Smith, operates a business called John Smith, Incorporated. For purposes of identifying the grantor of a security right over the assets of the business, only the identifier John Smith, Incorporated is correct.

74. Typically, States will also ensure that the rules specifying grantor identifiers provide clear guidance in cases where individuals are carrying on a business in another name or in a partnership that does not have a legal personality. For example, if an individual (for example, John Smith) carries on business as Smith's Plumbing without incorporating Smith's Plumbing as a company, the only correct identifier of the grantor of security is John Smith. States often, however, provide registrants with the option of also entering the business name as a named grantor on the notice subject to the caution that the correct legal name is the name of the proprietor and the notice is invalid if only the business name is entered.

(v) *Impact of a change in the grantor's identifier on the effectiveness of registration*

75. The name or other identifier of the grantor may change after registration, for example, as a result of a legal change of name by a grantor who is a natural person or a consolidation or other similar act by virtue of which a grantor that is a legal person continues in business under a different name. Such a subsequent change in the grantor's name or other applicable identifier raises problems for the discovery of previously registered notices. The grantor's identifier is the principal search criterion and a search using the grantor's new identifier will not disclose a security right registered against the old name. Therefore, in order to protect third parties that may deal with the grantor under its new name, some States require the secured creditor to amend the registered notice to disclose the grantor's new identifier before the expiry of a specified time period. Failure to do so does not make the registration ineffective. However, the priority of the security right is subordinated to the rights of secured creditors, buyers, lessees and licensees that acquire rights in or in relation to the encumbered assets after the identifier changes but before the amendment notice is registered. A secured creditor nonetheless retains whatever priority it enjoyed against these classes of competing claimants if their rights arose prior to the change of name. This approach reflects the purpose of requiring disclosure, that is, to protect third parties that might otherwise rely to their detriment on a "clean" search result made against the grantor's new name.

76. A grantor is normally obligated, either by the security agreement or by law, to inform the secured creditor of any change of name or other legal identifier. In some States, the grace period given to the secured creditor to amend the notice begins to run only once the secured creditor learns of the change of the grantor's identifier. In other States, the grace period commences when the change of name occurs. Failure to amend the notice before the expiry of the grace period results in a loss of priority to intervening competing claimants whether or not the secured creditor finds out about the change prior to the expiry. This is the approach recommended in the *Guide* as achieving the appropriate balance between the rights of the secured creditor and the rights of third-party searchers, taking into account that a secured creditor is likely to learn of the name change in any event as a consequence of its usual monitoring activities (see recommendation 61).

77. Under the recommended approach, a failure to register an amendment after a change of name creates a priority risk for secured creditors only when the competing claimant is a buyer, secured creditor, lessee or licensee. Failure to amend the notice does not affect the third-party effectiveness of the security right achieved by the original registration as against a grantor's judgement creditors or insolvency representative. This is because unsecured creditors are not reliance creditors in the sense that a negative search of the registry is a pre-condition to their decision to lend. Consequently, the *Guide* takes the view that, in balancing the rights of the secured creditor as against the interests of third parties, the secured creditor should be favoured.

(vi) *Impact of a transfer of an encumbered asset on the effectiveness of registration*

78. As with a change in the original grantor's name or other identifier, after a transfer of encumbered assets by the grantor, a search against the transferee's name by third parties dealing with the encumbered assets in the hands of the transferee will not disclose a security right created by the transferor. In this situation, some States adopt the approach recommended in the *Guide* with regard to a change of name by the grantor, as described in the preceding section. Under this approach, the secured creditor must register an amendment disclosing the transferee as a new grantor within a specified time period after the transfer to preserve priority over secured creditors and buyers that acquire rights in the encumbered assets after the transfer. If the amendment is not made within the specified time period, third-party effectiveness achieved with the original registration is not affected. However, the secured creditor is subordinated to intervening secured creditors and buyers whose rights arise after the transfer and before the amendment is registered.

79. As with the case of a change of name, other States take the position that the grace period for amendment should be triggered only once the secured creditor acquires actual knowledge of the grantor's transfer of the encumbered asset. This approach is based on the idea that a secured creditor is unlikely to become aware of an unauthorized transfer of the encumbered asset by the grantor until well after the fact since, unlike the situation with a change of name, the grantor will probably take active steps to hide its unauthorized activity from the secured creditor's knowledge. Still other States take the position that a secured creditor's priority position should never be prejudiced by a grantor's unauthorized transfer in breach of the security agreement, and thus that the secured creditor's decision to register an amendment to disclose the name of the transferee as a new grantor should be strictly voluntary. These latter two approaches reflect the view, to varying degrees, that in the case of unauthorized transfers the rights of secured creditors should prevail over the interests of competing claimants in being able to rely on a "clean" search of the registry against the name of the person in possession of encumbered assets.

80. The *Guide* does not make a specific recommendation on this point beyond stating that the issue needs to be addressed explicitly by enacting States (see recommendation 62). It was thought that the appropriate approach should be left for each State to decide in the context of its own credit market, taking into account the perceived level of local risk of grantor misbehaviour in the form of an unauthorized transfer of encumbered assets.

(b) *Secured creditor's identifier*

81. States that have established a general security rights registry (or indeed any type of registry) invariably require the registered notice to state the name or other identifier and address of the secured creditor, or its representative or nominee (see recommendation 57, subparagraph (a)). However, since this data is never a search criterion, registration errors do not pose the same risk of misleading third-party searchers compared to errors in the entry of the grantor's identifying data. On the other hand, accurate entry is still important since it enables interested third-party searchers to seek further information, for example, as to whether there is in fact a security right in the grantor's assets and the current details of the financing relationship. Accurate entry also provides presumptive evidence that a secured creditor that later claims a priority based on the notice is in fact the person entitled to do so. Accordingly, the *Guide* recommends that an incorrect statement by the registrant in the identifier or address of the secured creditor does not render a registered notice ineffective unless it would seriously mislead a reasonable searcher (see recommendation 64).

(c) *Description of assets covered by the notice*

82. In theory, in a notice-registration system there is no absolute necessity for the registration to identify the encumbered assets, as the mere existence of a notice indexed under the grantor's name or other identifier is sufficient to warn third parties about the possible existence of a security right in one or more of the grantor's assets. However, the absence of any description in the notice might limit the grantor's ability to sell or create a security right in assets that remain unencumbered. Prospective buyers and secured creditors would require some form of protection (for example, a release from the secured creditor) before entering into transactions involving any of the grantor's assets. The absence of a description would also diminish the information value of the registry for insolvency representatives and judgement creditors. For these reasons, the *Guide* recommends that a description of the encumbered assets be included in the registered notice (see recommendation 57, subparagraph (b)).

83. Although a description of the encumbered assets is required, modern registry regimes do not require a specific item-by-item description. The information needs of searchers are sufficiently served by a general description (for example, "all tangible assets" or "all receivables") or even an all-encompassing description (for example, "all present and future movable assets"). Indeed, the possibility of providing only a general description is necessary to ensure the efficient registration of a security right granted in future assets and in revolving categories of assets, such as inventory or receivables. These same considerations underlie the recommendations of the *Guide* on the description requirements for security agreements. Accordingly, the *Guide* recommends that a description of an encumbered asset in a notice that meets the description requirements for security agreements, that is, a description that reasonably allows the identification of an encumbered asset (see recommendation 14, subparagraph (d)), is likewise sufficient for a registered notice (see recommendation 63). The recommended approach also enhances the efficiency of the registration process because it enables secured creditors simply to transpose the description from the security agreement to the registered notice (and vice versa).

84. Unlike the grantor's name or other identifier, the description of the encumbered assets set out in a registered notice is not a search criterion. Consequently, the standard for accuracy in the description is not as high as in the case of a grantor's identifier. Since the purpose of the notice is to alert third-party searchers to the possibility that a security right may be claimed in specific assets, the basic question is whether, despite the error, the searchers would still understand that the description covered the relevant asset. In line with this policy and consistent with the approach usually taken in States that have established a general security rights registry, the *Guide* recommends that an incorrect statement by the registrant in the description of an encumbered asset does not render a registered notice ineffective unless it would seriously mislead a reasonable searcher (see recommendation 65). The term "reasonable searcher" indicates that the test should be objective. That is, the basic issue is whether a searcher in the abstract would be misled and it is unnecessary for a competing claimant who challenges the description to establish that it was actually misled. To adopt a subjective approach would invite litigation and might encourage a level of carelessness in entering descriptions.

85. One situation where even an apparently minor error in the description might nonetheless invalidate a registration is where a State decides to introduce a supplementary asset-specific search criterion for limited types of encumbered assets based on a unique numerical identifier (see paras. 34 and 35 above and 115 below). Since the identifier of the asset operates as a search criterion in this situation, it is essential to the sufficiency of the registered notice to enter the identifier in a manner that ensures its retrieval by third parties conducting a search according to the correct identifier.

86. Where an error is sufficient to trigger the "seriously misleading" test of invalidity, the *Guide* recommends that the extent of the invalidity should be limited to the insufficiently described assets rather than invalidating the notice altogether. That is, to the extent that the notice also includes assets that are appropriately described, the registration should remain valid with respect to those assets, since the error does not mislead reasonable searchers with respect to those assets (see recommendation 65).

(d) Duration and extension of the registration of a notice

87. The duration of secured financing transactions can vary considerably. This, in turn, requires some flexibility in the duration of the registered notices pertaining to such transactions. The necessary flexibility can usually be accommodated in one of two ways. The first is to allow registrants to select the desired term of the registration with the right to register further extensions as appropriate. The second is for the system to set a universal fixed term (for example, five years), accompanied by a right to register extensions that will then take effect for additional equivalent terms. In either case, extension of the registration is effectuated through a notice of amendment submitted to the registry before expiry of the effectiveness of the notice.

88. In medium- and long-term financing arrangements, the first approach lessens the risk for secured creditors of a loss of priority for an inadvertent failure to register an extension in time. In short-term financing arrangements, the second approach reduces the risk for grantors that secured creditors will register for an inflated term out of an excess of caution. In order to encourage timely cancellation in systems that adopt the second

approach, a State may choose not to charge any fee for registration of a notice of cancellation. Furthermore, in order to discourage the selection of excessive registration terms, fees can be based on an incremental, sliding-scale of fees related to the length of the registration term selected. Some States also adopt a compromise position. Registrants can self-select the registration term and can extend the initial registration term, but this is subject to a maximum temporal limit (such as 10 years) for each registration or extension. The *Guide* recommends that both ways of setting the duration of the registration should be available to the parties (see recommendation 69).

89. States that adopt the self-selection approach must address the impact on the effectiveness of a registered notice of an incorrect statement by the registrant as to the duration of the registration. The *Guide* recommends that the error should not render the registered notice ineffective. However, this is subject to the important caveat that protection should be given to third parties that relied on the incorrect statement (see recommendation 66). In addressing how third-party reliance might arise, it is necessary to distinguish two situations.

90. The first is where the registrant enters a shorter term than it actually intended. In this situation, the registration will lapse at the end of the specified time and the security right will no longer be effective against third parties. While the secured creditor can re-establish third-party effectiveness, it will take effect against third parties only from that point forward (see recommendation 47).

91. The second situation is where the secured creditor specifies a longer term than it actually intended. In this situation, there appear to be no concerns with protecting third parties. If the security right referred to in the notice has in fact ended (for example, by payment of the secured obligation), then third-party effectiveness ceases in any event. If, on the other hand, the secured obligation is still outstanding, it is difficult to see how third parties could be prejudiced by relying on the incorrect statement, since the registered notice still alerts them to the security right and they can take steps to protect themselves against that risk. In this case, the secured creditor's error works to its advantage. However, since third parties are not prejudiced, there is no need to penalize the secured creditor in this circumstance.

(e) Maximum amount of secured obligations

92. States diverge on the question of whether the notice must disclose the monetary amount for which the security right covered by the notice may be enforced. No State with a modern registry regime requires the actual amount of the secured obligation to be stated, since this would prevent the creation of security rights to secure future or indeterminate obligations (see recommendation 16).

93. However, some States require that the registered notice include a statement of the maximum amount for which the security right covered by the notice may be enforced (see chapter II on the creation of a security right, paras. 43-47, and recommendation 14, subparagraph *(e)*). This approach is intended to facilitate the grantor's access to secured financing from other creditors in situations where the value of the assets encumbered by the prior registered security right exceeds the maximum amount indicated in the notice. It is based on the assumption that the residual value of the encumbered asset will enable the

grantor to obtain credit from other sources, even though that credit will be secured with a security right with a lower priority status than the security right securing the initially provided credit. It is also based on the assumption that the grantor will have sufficient bargaining power to ensure that the first-registered secured creditor does not register an inflated maximum amount. In States that follow this approach, the priority of the security right to which the notice relates over subsequent security rights is limited to the maximum amount set out in the notice.

94. In other States, there is no obligation to include a maximum sum in the registered notice. The first-registered secured creditor has priority with respect to all future payments it makes to the grantor in an unlimited amount, provided, as under the first approach, that either the existing security agreement or a future security agreement explicitly covers future obligations. Under this approach, a later secured creditor will not be prepared to lend against the current residual value of the encumbered assets since the first-registered secured creditor will retain priority for any later extension of credit it makes against that residual value. In States that adopt this approach, the concern is that requiring a maximum amount to be registered would: (a) limit the amount of credit available from the initial secured creditor; or (b) be ineffective in practical terms, since the initial secured creditor will simply require the grantor to consent to an inflated maximum sum to cover all possible future extensions of credit. This approach is based on the assumption that: (a) the first secured creditor is either the optimal long-term financing source or will be more likely to extend financing, especially to small, start-up businesses, if it knows that it will have a first priority for the grantor's future financing needs; (b) the grantor will not have sufficient bargaining power to require the first-registered secured creditor to enter a realistic maximum amount in the registered notice; and (c) a subsequent creditor to whom the grantor applies for financing will be in a position to negotiate a subordination agreement with the first-registered security creditor for credit extended on the basis of the current amount of excess value in the encumbered asset.

95. The *Guide* acknowledges that both approaches have merit and recommends that States adopt the policy that is most consistent with efficient financing practices in that State and, in particular, with the credit market assumptions that underlie each approach (see recommendation 57, subparagraph (d)).

96. States that adopt the requirement to specify a maximum amount on the registered notice will need to address the impact of an error by the registrant in entering the amount. On this issue, in line with the approach taken in States that already have this requirement, the *Guide* recommends that an incorrect statement does not render a registered notice ineffective except to the extent it misleads third parties (see recommendation 66). In this instance, the test of whether the error is seriously misleading is subjective; that is, a third party that challenges the notice on the basis of the error will need to show that it was actually misled by the error. A subjective test is appropriate here since the purpose of requiring the maximum sum to be inserted is to ensure that the grantor can seek additional financing on the basis of the residual value of assets already encumbered by a security right without the third-party financier having to worry about the value of its security right being undermined by a later advance from the first-registered secured creditor.

97. In determining what sort of error in the statement of maximum amount is likely to cause detrimental reliance by third parties, two situations should be distinguished. The

first is where the amount stated in the notice is greater than the maximum amount actually agreed to in the security agreement. Here, a third party is unlikely to be prejudiced since its decision to advance funds normally will be based on the amount stated in the registered notice. Moreover, the grantor in this situation can compel the first registered secured creditor to amend the notice to correct the amount so that it can obtain financing against the true value of the grantor's unencumbered right in the asset. The second situation is where the amount specified in the notice is less than the amount agreed to in the security agreement. This situation creates clear potential for misleading a third-party financier. Consequently, should a subsequent secured creditor register a security right and extend credit, the first secured creditor will normally be entitled to enforce its security right as against the third party only up to the amount specified in the registered notice.

6. *Advance registration and one registration for multiple security rights*

98. As already noted, in a notice-registration system the registered notice is independent from the security agreement and a registrant need not submit the underlying security documentation or provide other evidence of the security right to which the registration relates in order to register a notice. Notice registration thus removes any practical obstacle to registration in advance of the conclusion of a security agreement or, where an additional act is required for the creation of a security right (such as transfer of possession of the assets to the secured creditor), the creation of a security right (that is, "advance registration"). Consequently, among States that have adopted notice-registration, many allow registration to be made either before or after the security agreement is completed. Since a notice-registration system removes any practical necessity for the existence of a one-to-one relationship between the registration and the security agreement, States that adopt this approach usually also provide that the registration of a single notice is sufficient to achieve the third-party effectiveness of security rights in the assets described in the notice whether created under a single security agreement or multiple unrelated security agreements between the same parties, even if entered into at different times.

99. Advance registration offers several important advantages. First, it facilitates the grantor's access to credit because it enables a secured creditor, with whom the grantor is negotiating a security agreement, to establish its priority against other secured creditors under the general first-to-register priority rule without having to worry about the temporal sequence of registration and the formal signing of the security agreement. For example, it avoids the risk of secured creditor B obtaining priority by registering before the signing of a security agreement between the grantor and secured creditor A, but after secured creditor A registers. It also avoids the risk of a registration being ineffective in cases where the underlying security agreement is technically deficient at the point of registration but is later rectified. Moreover, it enhances the flexibility of the financing relationship between the parties, since it enables them to adjust the terms of the security arrangement and enter into new security agreements covering the same encumbered assets in response to the grantor's evolving financing needs and without registering new notices.

100. Among States that have established a general security rights registry, the usual approach is also to permit the notice to be registered before the security right referred to in the notice comes into existence. Since a security right can be created in a particular asset only when the grantor owns or has rights in the asset, registration in advance of the

creation of a security right accommodates efficient registration for security rights in future assets. Any other rule would require registration of a new notice each time the grantor acquires a new asset, making financing against the security of future assets, including inventory and receivables, administratively impossible.

101. For the preceding reasons, the *Guide* recommends that registration of a notice is effective to achieve third-party effectiveness whether it is made before or after the conclusion of the initial security agreement or the creation of security rights pursuant to that agreement or any other security agreements that may be entered into between the same parties covering the encumbered assets described in the notice (see recommendations 67 and 68).

7. Time of effectiveness of registration of a notice or amendment

102. As a general rule, priority between competing security rights that have been made effective against third parties only by registration depends on the order of registration (see recommendation 76, subparagraph (a)). It follows that the time at which a registration became legally effective is vital in determining priority among competing security rights. If a security right is already in existence, the time at which a registration takes legal effect may also be critical to the resolution of priority conflicts between a secured creditor and a buyer or lessee of the encumbered asset or a grantor's unsecured creditors and insolvency representative.

103. In a registry system that permits registrants to submit paper (even sent by fax) or telephone notices to the registry (as opposed to or as an alternative to direct electronic entries), there will inevitably be some delay between the time the notice is received in the office of the registry and the time when the information on the notice is entered into the registry record by the registry staff so as to be searchable by third parties. This time lag raises the question of when registration should be considered legally effective: the time when the notice is received in the registry office or the time when the information on the notice becomes publicly searchable.

104. In resolving this issue, many States place the priority risk created by a time lag on the secured creditor and not on third-party searchers. In these States, the policy rationale is that the effective time of registration should be concomitant with the ability of searchers to retrieve the notice. It would affect the reliability of the registry if third parties were to find themselves bound by a notice that was not publicly searchable. It is also thought that a secured creditor is in a better position to take steps to protect itself than third parties (for example, by withholding credit until the notice becomes searchable). In any event, the design and operation of a modern security rights registry should ensure speedy and efficient registration procedures that minimize delay. In a fully electronic system that requires no intervention by registry staff, entry of the notice and its availability to searchers is virtually simultaneous and the problem of a time lag between submission and third-party accessibility is essentially eliminated.

105. For these reasons, the *Guide* takes the position that the effective time of registration is the time at which third-party searchers are able to find the notice (see recommendation 70).

8. Authority for registration

106. In many States, registration of a notice is not effective unless it is made by the grantor (which is rare) or with the grantor's consent. However, these States usually provide that it is not necessary for the secured creditor to obtain the grantor's written authorization at or before the time registration is made or to establish to the registry that consent has been obtained. This approach is justified by the fact that permitting the authorization to be given either before or after registration eliminates what would be a significant source of delay and cost in the registration process, and avoids the risk that technical errors may undermine the third-party effectiveness of the security right otherwise obtained by registration (see recommendation 54, subparagraph (d)). In addition, there is no need to obtain the separate written consent of the grantor, as authorization will be treated as given implicitly by the fact that the parties entered into the security agreement. As discussed in the next section of this chapter, if no security agreement is ever entered into between the parties, modern regimes enable the grantor to request cancellation of the registration through summary judicial or administrative proceedings and other law may provide penalties for fraudulent registrations. Consequently, the practical result is much the same as in States that do not explicitly require formal written authorization from the grantor (on the assumption that the security agreement constitutes consent). The *Guide* recommends this approach (see recommendation 71).

9. Cancellation or amendment of a registered notice

(a) Compulsory cancellation or amendment

107. For reasons of security, many States provide that only the secured creditor (or its authorized representative) has the authority to cancel or amend a registration. However, a registration that does not in fact represent an existing or potential security right can have a prejudicial impact on the ability of the person named as grantor in the notice to sell or create a security right in the assets described in the notice. It is, therefore, essential to ensure that registered notices are cancelled or amended promptly if: (a) no security agreement exists or is contemplated; (b) the security right has been extinguished by full and final satisfaction of the secured obligation; or (c) a registered notice contains information not authorized by the grantor (for example, the asset description contained in the notice may be overly broad, including items or types of asset that are not intended to be the object of any actual or contemplated security agreement between the parties).

108. To protect grantors in these circumstances, a number of States entitle the grantor to send a written demand to the secured creditor to discharge or amend the registration to reflect the actual status of their relationship. The secured creditor is obliged to register a notice of cancellation or amendment, as the case may be, within a specified time period (for example, 20 or 30 days) after receipt of the demand. If the secured creditor fails to comply, the grantor is then entitled to compel cancellation or amendment of the notice through a summary administrative or, less commonly, judicial procedure (see recommendations 72 and 74). The *Guide* recommends this approach. In these States, unless the secured creditor obtains a contrary court order, non-compliance entitles the grantor to require the registrar to register the discharge or amendment on proof to the registrar that the demand was made and not satisfied and after notice to the secured creditor. A few of

these States even entitle the grantor to cancel or amend the registration unilaterally, although they also impose a liability for damages on a grantor that does so without having followed the required demand procedures.

(b) Expunging and archiving of cancelled notices

109. Once a registered notice has expired or been cancelled, the registry system is normally programmed to ensure that it is promptly removed from the publicly searchable records of the registry. However, the information provided in the expired or cancelled notice and the fact of expiration or cancellation is archived so as to be capable of retrieval in the future if necessary. Retrieval might be necessary, for example, to establish the priority of the registered security right at a particular point in time. The *Guide* recommends this approach to expunging and archiving cancelled notices (see recommendation 74).

(c) Amendments

110. As already discussed (see paras. 75-77 above), secured creditors must register an amendment to disclose a subsequent change in the grantor's identifier in order to preserve priority against secured creditors and buyers that deal with the encumbered assets after the change. In contrast, while most States permit the secured creditor to amend the registered notice to disclose a change in its identifier, the registered notice retains its legal effectiveness even if the amendment is not made. This is because, unlike the grantor's identifier, the secured creditor's identifier is not a search criterion. Thus, a change in the secured creditor's identifier does not prejudice the ability of third-party searchers to retrieve the notice.

111. However, even though it is optional, it is normally prudent for a secured creditor to register an amendment in order to disclose a change in its identifier set out in the original registered notice. Where the change involves a change of identifier or address, failure to register exposes the secured creditor to the risk that it will not receive notices sent from third parties relating to the security right referred to in the registered notice. Where the subsequent change results from an assignment of the original secured obligation, the new secured creditor's omission to ensure registration of the amendment means that the original secured creditor retains the legal power to alter the state of the record. The *Guide* recommends this approach (see recommendation 75).

112. The situation is different where the security right is not registered or otherwise made effective against third parties at the time of an assignment of the secured obligation and ancillary security right to a new secured creditor. Here, the assignee will need to register a notice in order to make the security right effective against third parties. There is no reason why the notice may not name the assignee as the secured creditor. In other words, there is no need for the registrant to first register in the name of the original secured creditor.

113. If the grantor's financing needs change after the conclusion of the original security agreement, the grantor may agree to create a security right in additional assets. In the interest of flexibility, the registry system may allow the description in the registered notice to be amended to add the newly encumbered assets rather than requiring a new notice to

be registered. However, the amendment is effective with respect to the newly encumbered assets only from the date it is registered, with the result that it cannot prejudice third-party rights acquired in the additional assets prior to registration of the amendment.

114. The situation is different when the amendment reflects new assets in the form of proceeds of the original encumbered assets. If the amendment is made before the expiry of the applicable period of temporary automatic third-party effectiveness, the security right in the proceeds takes effect against third parties as of the date of registration of the original notice (see chapter III on the effectiveness of a security right against third parties, paras. 92-93).

115. If the description in the original registration covers future assets, there is normally no need to amend the registration. However, if the system adopts supplementary asset registration for future serially numbered goods (see paras. 34, 35 and 85 above), it will be necessary to amend the registration to include the new serial numbers in order for the security right to take effect against third parties.

116. Where a secured creditor agrees to subordinate a registered security right to the right of another creditor, registration of an amendment to disclose the subordination should not be required in principle to preserve the effectiveness of the registration. As the subordination only affects the priority position of the relevant parties as against each other, such an approach does not prejudice the rights of third parties.

10. *Specialized registries*

117. Where registration of a security right is made in a specialized registry, many of the same considerations discussed in this chapter are present. However, because the purposes, organization and administration of specialized registries vary from State to State and sometimes from registry to registry, the *Guide* makes no formal recommendations with respect to their design and operation. Nonetheless, States may wish to treat the establishment or reform of a general security rights registry as an opportunity to also reform their specialized registries to ensure an equivalent level of modern and efficient operation, such as by introducing a notice-registration approach to the recording of security rights (see chapter III on the effectiveness of a security right against third parties, paras. 75-82).

B. Recommendations 54-75

Purpose

The purpose of provisions on the registry system is to establish a general security rights registry and to regulate its operation. The purpose of the registry system is to provide:

- (a) A method by which an existing or future security right in a grantor's existing or future assets may be made effective against third parties;
- (b) An efficient point of reference for priority rules based on the time of registration of a notice with respect to a security right; and

(c) An objective source of information for third parties dealing with a grantor's assets (such as prospective secured creditors and buyers, judgement creditors and the grantor's insolvency representative) as to whether the assets may be encumbered by a security right.

To achieve this purpose, the registry system should be designed to ensure that the registration and searching processes are simple, time- and cost-efficient, user-friendly and publicly accessible.

Operational framework of the registration and searching processes

54. The law should ensure that:

(a) Clear and concise guides to registration and searching procedures are widely available and information about the existence and role of the registry is widely disseminated;

(b) Registration is effected by registering a notice that provides the information specified in recommendation 57, as opposed to requiring the submission of the original or a copy of the security agreement or other document;

(c) The registry accepts a notice presented by an authorized medium of communication (for example, paper, electronic) except if:

(i) It is not accompanied by the required fee;

(ii) It fails to provide a grantor identifier sufficient to allow indexing; or

(iii) It fails to provide some information with respect to any of the other items required under recommendation 57;

(d) The registrar does not require verification of the identity of the registrant or the existence of authorization for registration of the notice or conduct further scrutiny of the content of the notice;

(e) The record of the registry is centralized and contains all notices with respect to security rights registered under this law;

(f) The information provided on the record of the registry is available to the public;

(g) A search may be made without the need for the searcher to justify the reasons for the search;

(h) Notices are indexed and can be retrieved by searchers according to the identifier of the grantor;

(i) Fees for registration and for searching, if any, are set at a level no higher than necessary to permit cost recovery;

(j) If possible, the registration system is electronic. In particular:

(i) Notices are stored in electronic form in a computer database;

(ii) Registrants and searchers have immediate access to the registry record by electronic or similar means, including the Internet and electronic data interchange;

(iii) The system is programmed to minimize the risk of entry of incomplete or irrelevant information; and

(iv) The system is programmed to facilitate speedy and complete retrieval of information and to minimize the practical consequences of human error;

(k) Registrants may choose among multiple modes and points of access to the registry; and

(l) The registry, to the extent it is electronic, operates continuously except for scheduled maintenance, and, to the extent it is not electronic, operates during reliable and consistent service hours compatible with the needs of potential registry users.

Security and integrity of the registry

55. In order to ensure the security and integrity of the registry, the law should provide that the operational and legal framework of the registry should reflect the following characteristics:

(a) Although the day-to-day operation of the registry may be delegated to a private authority, the State retains the responsibility to ensure that it is operated in accordance with the governing legal framework;

(b) The identity of a registrant is requested and maintained by the registry;²

(c) The registrant is obligated to forward a copy of a notice to the grantor named in the notice. Failure of the secured creditor to meet this obligation may result only in nominal penalties and any damages resulting from the failure that may be proven;

(d) The registry is obligated to send promptly a copy of any changes to a registered notice to the person identified as the secured creditor in the notice;

(e) A registrant can obtain a record of the registration as soon as the registration information is entered into the registry record; and

(f) Multiple copies of all the information in the records of a registry are maintained and the entirety of the registry records can be reconstructed in the event of loss or damage.

Responsibility for loss or damage

56. The law should provide for the allocation of responsibility for loss or damage caused by an error in the administration or operation of the registration and searching system. If the system is designed to permit direct registration and searching by registry users without the intervention of registry personnel, the responsibility of the registry for loss or damage should be limited to system malfunction.

Required content of notice

57. The law should provide that the following information only is required to be provided in the notice:

(a) The identifier of the grantor, satisfying the standard provided in recommendations 58-60, and the secured creditor or its representative and their addresses;

(b) A description of the asset covered by the notice, satisfying the standard provided in recommendation 63;

(c) The duration of the registration as provided in recommendation 69; and

(d) If the State determines that an indication in the notice of the maximum monetary amount for which the security right may be enforced would be helpful in order to facilitate subordinate lending, a statement of that maximum amount.

Sufficiency of grantor identifier

58. The law should provide that registration of a notice is effective only if it provides the grantor's correct identifier or, in the case of an incorrect statement, if the notice would be retrieved by a search of the registry record under the correct identifier.

59. The law should provide that, where the grantor is a natural person, the identifier of the grantor for the purposes of effective registration is the grantor's name, as it appears in a specified

²As to the verification of the registrant's identity, see recommendation 54, subparagraph (d).

official document. Where necessary for the unique identification of the grantor, additional information, such as the birth date or identity card number, should be required.

60. The law should provide that, where the grantor is a legal person, the grantor's identifier for the purposes of effective registration is the name that appears in the document constituting the legal person.

Impact of a change of the grantor's identifier on the effectiveness of the registration

61. The law should provide that, if, after a notice is registered, the identifier of the grantor changes and as a result the grantor's identifier set forth in the notice does not meet the standard provided in recommendations 58-60, the secured creditor may amend the registered notice to provide the new identifier in compliance with that standard. If the secured creditor does not register the amendment within [a short period of time to be specified] days after the change, the security right is ineffective against:

(a) A competing security right with respect to which a notice is registered or which is otherwise made effective against third parties after the change in the grantor's identifier but before registration of the amendment; and

(b) A person that buys, leases or licenses the encumbered asset after the change in the grantor's identifier but before registration of the amendment.

Impact of a transfer of an encumbered asset on the effectiveness of the registration

62. The law should address the impact of a transfer of an encumbered asset on the effectiveness of registration.

Sufficiency of description of an asset covered by a notice

63. The law should provide that a description of an encumbered asset in a notice that meets the requirements of recommendation 14, subparagraph (d) (chapter II on the creation of a security right), is sufficient.

Consequences of an incorrect statement or insufficient description

64. The law should provide that an incorrect statement by the registrant of the identifier or address of the secured creditor or its representative or a description of the encumbered asset that does not meet the requirements of recommendation 63 does not render a registered notice ineffective unless it would seriously mislead a reasonable searcher.

66. The law should provide that a description of certain encumbered assets that does not meet the requirements of recommendation 63 does not render a registered notice ineffective with respect to other assets sufficiently described.

66. The law should provide that an incorrect statement in the notice with respect to the duration of registration and the maximum amount secured, if applicable, does not render a registered notice ineffective. Third parties that relied on such incorrect statements should be protected.

When notice may be registered

67. The law should provide that a notice with respect to a security right may be registered before or after:

- (a) The creation of the security right; or
- (b) The conclusion of the security agreement.

One notice sufficient for multiple security rights arising from multiple agreements between the same parties

68. The law should provide that registration of a single notice is sufficient to achieve third-party effectiveness of one or more than one security right, whether they exist at the time of registration or are created thereafter, and whether they arise from one or more than one security agreement between the same parties.

Duration and extension of the registration of a notice

69. The law should either specify the duration of the effectiveness of the registration of a notice or permit the registrant to specify the duration in the notice at the time of registration and extend it at any time before its expiry. In either case, the secured creditor should be entitled to extend the period of effectiveness of the registration by submitting a notice of amendment to the registry at any point in time before the expiry of the effectiveness of the notice. If the law specifies the duration of effectiveness of the registration, the extension period resulting from the registration of the notice of amendment should be an additional period equal to the initial period. If the law permits the registrant to specify the duration of the effectiveness of the registration, the extension period should be that specified in the notice of amendment.

Time of effectiveness of registration of a notice or amendment

70. The law should provide that registration of a notice or an amendment becomes effective when the information contained in the notice or the amendment is entered into the registry records so as to be available to searchers of the registry record.

Authority for registration

71. The law should provide that registration of a notice is ineffective unless authorized by the grantor in writing. The authorization may be given before or after registration. A written security agreement is sufficient to constitute authorization for the registration. The effectiveness of registration does not depend on the identity of the registrant.

Cancellation or amendment of notice

72. The law should provide that, if no security agreement has been concluded, the security right has been extinguished by full payment or otherwise, or a registered notice is not authorized by the grantor:

- (a) The secured creditor is obliged to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant registered notice not later than [a short period of time to be specified] days after the secured creditor's receipt of a written request of the grantor;

(b) The grantor is entitled to seek cancellation or appropriate amendment of the notice through a summary judicial or administrative procedure;

(c) The grantor is entitled to seek cancellation or appropriate amendment of the notice, as provided in subparagraph (b), even before the expiry of the period provided in subparagraph (a), provided that there are appropriate mechanisms to protect the secured creditor.

73. The law should provide that the secured creditor is entitled to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant registered notice at any time.

74. The law should provide that promptly after a registered notice has expired as provided in recommendation 69 or has been cancelled as provided in recommendation 72 or 73, the information contained in the notice should be removed from the records of the registry that are accessible to the public. However, the information provided in the expired or cancelled or amended notice and the fact of expiration or cancellation or amendment should be archived so as to be capable of retrieval if necessary.

75. The law should provide that, in the case of an assignment of the secured obligation, the notice may be amended to indicate the name of the new secured creditor. However, a notice not so amended remains effective.

V. Priority of a security right

A. General remarks

1. Introduction

1. The concept of priority is at the core of every successful secured transactions regime. It is the primary means by which States resolve conflicts of rights in a grantor's assets among competing claimants. The concept is reflected in the set of principles and rules governing the extent to which a secured creditor may obtain the economic benefit of its right in an encumbered asset in preference to any other competing claimant that derives its rights in that asset from the same grantor.

2. The logic and limits of the concept of priority are best understood against the backdrop of a State's general law of debtor-creditor relations. In some States, debtor-creditor law does not directly concern itself with the relationship among a debtor's various creditors; it only deals with the relationship between the debtor and a particular creditor. Upon default, a creditor can obtain a court judgement against its debtor and then simply seize and sell the debtor's (if the grantor is a different person, the grantor's) assets to pay the amount owed as determined by the court. Under general debtor-creditor law in these States, the concept of priority (that is, which of two or more claimants may derive first the economic benefit of its right in an asset) is relevant only when a competing claimant contests a secured creditor's right to enforce its security right in one or more of the debtor's assets. This might occur, for example, where a creditor seizes assets found on the debtor's premises that may in fact belong to a third party.

3. In most States, however, debtor-creditor law is more broadly cast and is also more explicit about how relationships among all of a debtor's creditors are to be regulated. In these States, two general principles usually govern these relationships. First, the law typically provides that all of a debtor's assets may be seized and sold to satisfy an obligation confirmed by a judgement in favour of any one creditor (a debtor's assets are the "common pledge" of its creditors). However, if other creditors have also obtained a judgement against the debtor and join the seizure, the proceeds of sale are used to satisfy the claims of all creditors that have joined in. Second, in the event that there is not enough money generated by the sale of assets to pay all these creditors in full, their claims are discounted proportionally and they share in the proceeds of sale in proportion to the respective amounts of their claims (that is, they share *pro rata*).

4. Although both of the principles mentioned in the preceding paragraph are part of the law of many States, the debtor-creditor law in these States has evolved to include other principles as well. Most importantly, in these States it is possible for some specific creditors to obtain a preference over other creditors. In other words, the two basic principles govern all debtor-creditor relationships only where one or more creditors have not contracted with their debtor for a preference.

5. There are several ways in which creditors may contract for a preferential right. For example, in many States sellers use devices such as retention of title to prevent certain assets from becoming part of the common pledge otherwise available to all creditors. Similarly, in many States lenders may use a device such as a sale with a right of redemption to withdraw certain of a debtor's assets from the common pledge. Having done so, these creditors can enhance the likelihood of receiving full payment of any obligations owed to them since they no longer have to share with competing claimants the economic value of the assets subject to such devices. In addition, in most States certain creditors are authorized to obtain a preferential right in the distribution of the proceeds of a sale in realization of their claims. This preference can arise either by virtue of a legislatively determined preference (such as that often awarded to repairers of assets, unpaid sellers of assets and taxing authorities) or by entering into a contract to obtain a security right in specific assets of the debtor. In these cases, the right of certain creditors to be paid in preference to other creditors directly enhances the likelihood that they will receive full payment of their claims, since competing claimants will be paid only after the claims of preferred creditors have been fully satisfied. Sorting through the underlying policies and the consequences of awarding certain creditors a preference over competing claimants is one of the key purposes of rules governing priority.

6. States take different general approaches to creating a set of priority rules. In some States the concept is given a rather narrow meaning in the sense that it is used only in reference to competitions between claimants that have obtained a preference through a disruption of the principle of creditor equality. In these States, priority does not address issues of title. Competitions involving other claimants whose claims do not involve the assertion of rights in one or more of the assets owned by a debtor (notably sellers that have retained title and subsequent acquirers of a debtor's assets) are not normally characterized as priority conflicts. These competitions are resolved, first and foremost, by determining whether the claimant or the debtor has title to the asset in question (by reference to general principles of property law, such as the principle that nobody can transfer to another person more rights than the transferor has: *nemo dat quod non habet*). Moreover, in these States questions of priority usually arise only when a creditor seeks to enforce its claim against its debtor's assets; the concept of priority has no material relevance prior to that time.

7. In other States, the term priority has a broader scope in the sense that it is used in reference to any competition between all claimants that have property rights in the assets of their debtor, including assets in the possession of the debtor and in respect of which the debtor has only a right of use, even though it may not actually yet own them (a debtor's ostensible assets). For example, in these States the conflict between a seller that has retained title to an asset, a third party to which the debtor has purportedly sold the asset and a judgement creditor of that third party with a right in the asset is characterized as a priority conflict. Furthermore, in these States the concept of priority governs the relationship between competing claimants even before a debtor is in default. Thus, a competition between the transferee of a claim (such as a receivable) and a creditor that is collecting the claim is viewed as a priority competition, even though the debtor may not yet be in default towards the collecting creditor. Similarly, if two secured creditors have contracted with a grantor to obtain possession of an encumbered asset upon demand prior to default, the competition between them is a priority competition, even though the debtor may not yet be in default towards either one.

8. Some States take an even broader view of priority in the sense that they consider priority competitions between creditors and claimants whose rights are not derived from the same debtor to be priority competitions that are subject to secured transactions law. For example, grantor A creates a security right in favour of creditor M and leases the encumbered asset to lessee X, prior to selling the asset to buyer B. Buyer B then grants a security right in that asset to creditor N and leases the encumbered asset to lessee Y. Even though their rights are granted by two different debtors (A and B), the competition between M, N, X and Y is considered to be a priority competition. In other States, by contrast, the concept of priority only arises where the competing claimants derive their rights from the same grantor. Where two different grantors have created rights in the same asset, these States rely on other law, such as basic property law or the law of sale, to provide the principles (such as the principle of *nemo dat quod non habet*) governing the competing rights of the two classes of creditors (A's creditors on the one hand, and B's creditors on the other).

9. In chapter I on the scope of application, basic approaches to security and general themes common to all chapters of the *Guide*, the *Guide* recommends that States adopt a fully integrated and comprehensive approach to secured transactions as a general organizing framework. Except in connection with the non-unitary approach to acquisition financing (see recommendation 9), whether a creditor seeks to obtain a preference by contracting to overcome the principle of the common pledge or the principle of creditor equality, the agreement will be characterized as giving rise to a security right and the rights of competing claimants will be resolved as priority disputes (see recommendation 8). Nonetheless, because States may have different policies relating to basic issues of property law, the *Guide* does not deal with competitions between claimants whose rights are not derived from the same grantor. These matters are left to other law of a State. Thus, in the present chapter and throughout the *Guide*, the term priority is used to encompass only competitions, whether prior to default or at the time of enforcement, between a secured creditor and any other claimants that take their rights from the same grantor (see, for example, recommendation 76).

10. This chapter discusses, in section A.2, general approaches to drafting priority rules and, in section A.3, the various means by which priority may be determined. The chapter then turns to a review of the key priority rules that should be part of a modern secured transactions regime. Section A.4 considers the relationship among the various competing claimants and section A.5 addresses the scope and interpretation of priority rules. Section B reviews special priority rules that apply only to certain specific categories of assets. The chapter concludes, in section C, with a series of recommendations.

2. *The domain of priority*

(a) *Types of priority competition*

11. Before examining why the concept of priority is so important (see paras. 16-19 below), the various situations in which questions of priority arise are discussed so as to explain the relevant context. Issues of priority typically arise in three main contexts, all of which presume that at least one of the competing claimants is a secured creditor (that is, the holder of a contractual security right).

12. Most commonly, priority issues become relevant at the time of enforcement of a security right, such as where the grantor of a security right in an encumbered asset defaults on its secured obligation and where the value of the encumbered asset is not sufficient to satisfy the obligations owed to the enforcing creditor and all other competing claimants asserting a right in the asset. In these situations, secured transactions law must determine how the economic value of the asset is to be allocated among them. Often, the competing claimant will be another secured creditor of the grantor. A typical example is where a grantor has granted security rights in the same asset to two different lenders. However, in other cases the competing claimant may be the holder of another type of property right, such as a right created by statute (for example, a preferential creditor) or an unsecured creditor of the grantor that has obtained a judgement against the grantor and has taken steps to enforce the judgement against assets encumbered by the security right.

13. Priority issues also arise where a third party asserts a claim to an encumbered asset that will, if successful, enable the third party to obtain a clear title to the asset, that is, free of all security rights in the asset and other competing claims to the asset, or a right to use the asset under a lease or licence agreement. A typical example is where a grantor creates a security right in favour of a lender but retains possession of the asset and then sells the encumbered asset to a third party. In this situation, the secured transactions law must determine whether the buyer of the asset acquires title to the asset free of the lender's security right. Another example is where a grantor creates a security right in an asset in favour of a lender and then leases or licenses the asset to a third party. Here, the secured transactions law must determine whether the lessee or licensee may enjoy its rights under the lease or license unaffected by the lender's security right. Yet another example arises where the insolvency representative in a grantor's insolvency proceedings claims the assets encumbered by a creditor's security right for the benefit of the insolvency estate.

14. A third context in which priority competitions arise does not presume that an enforcement process has begun or even that another claimant has asserted a right to obtain clear title to the encumbered asset. A grantor may, for example, create two security rights in a receivable and also agree to permit each secured creditor to collect the receivable, deducting the amount due under the secured obligation from the payments received on a monthly basis and remitting the balance (if any) to the grantor. Even if the grantor is not in default, it will still be necessary to determine which of the secured creditors has the right to collect the receivable. A similar competition could arise where the grantor gives two secured creditors the right to possession of the encumbered asset upon demand while the security agreement is in effect. In both these examples, the respective rights of the two creditors will be determined by the priority rules of secured transactions law.

15. It is important to note that in all of the cases just mentioned, most States take the position that priority is an issue only if the security rights involved in the priority dispute are effective against third parties (as to the distinction between effectiveness as between the parties and effectiveness as against third parties, see chapter II on the creation of a security right, paras. 1-7). Nonetheless, some States attach priority consequences to certain rights even though they may not be fully effective against third parties. For example, in these States there may be special priority rules meant to govern competitions only between two or more secured creditors that have not yet made their rights effective against third parties. In States that draw a sharp distinction between rights that are effective against third parties and those which are not, however, security rights that are not effective against

third parties have the same ranking, both as against each other and as against the rights of ordinary unsecured creditors. That is, they have no priority whatever over other rights. Moreover, in these States competing claimants that benefit from a preferred status under other law (for example, providers of services such as repairers and other creditors that are given a legislative preference) or that acquire title to assets from the grantor will always have priority over a security right that has not been made effective against third parties. It should be noted, finally, that even if security rights are not effective against third parties and produce no priority consequences, they are, nevertheless, effective and enforceable against the grantor. The approach of attaching no third-party consequences to security rights that have not been made effective against third parties is the approach recommended in the *Guide* (see recommendation 30).

(b) The importance of priority rules

16. For a number of reasons, it is widely recognized that effective priority rules are fundamental to promoting the availability of secured credit.

17. To begin, the most critical issue for a creditor that is considering extending credit secured by particular assets is what the priority of its security right will be in the event the creditor seeks to enforce the security right either within or outside the grantor's insolvency proceedings. More specifically, the question is how much the secured creditor might reasonably anticipate deriving from the sale of encumbered assets. This question is especially important where the encumbered assets are expected to be the creditor's primary or only source of repayment. To the extent that the creditor is uncertain about the priority of its prospective security right at the time it is evaluating whether to extend credit, it will place less reliance on these encumbered assets as a source of repayment. This uncertainty about how much can be realized by the sale of the assets may induce the creditor to increase the cost of the credit (for example, by charging a higher interest rate) or to reduce the amount of the credit (for example, by advancing a smaller percentage of the value of the encumbered assets). In some cases, the uncertainty may even cause the creditor to refuse to extend credit altogether.

18. To minimize this uncertainty, it is important that secured transactions laws include clear priority rules that lead to predictable outcomes in any competition between claimants to the encumbered assets. In addition, because security rights will have almost no value to secured creditors unless they are enforceable in a grantor's insolvency proceedings, it is important that these outcomes are respected by the insolvency law of a State to the maximum extent possible (see chapter XII on the impact of insolvency on a security right, paras. 13 and 59-63). This is especially important because, in many cases, default in respect of a secured creditor may occur concurrently with defaults in respect of other creditors, a circumstance that may trigger the commencement of insolvency proceedings.

19. Well-conceived priority rules can also have another positive impact on the overall availability of secured credit. Many banks and other financial institutions are willing to extend credit based upon obtaining security rights that are subordinate to one or more other higher-ranking security rights held by other secured creditors, so long as they perceive that there is residual value in the grantor's assets (over and above the other secured obligations) to support their security rights and so long as they can clearly confirm the precise priority of their security rights. This presupposes that the prospective creditor is

able to determine the maximum amount secured by the higher-ranking security rights, either by communicating with the holders of the other security rights or, in States that require a public statement of the maximum amount for which a security right encumbers an asset, by consulting the registered notice in the general security rights registry (see para. 139 below and recommendation 98). Alternatively, in situations where the prospective secured creditor is unable to satisfy itself that sufficient residual value exists to support the proposed new grant of credit, the secured creditor may be able to create sufficient value by negotiating a subordination agreement with one or more higher-ranking secured creditors. In these agreements, the higher-ranking creditors would either subordinate their security rights in specific assets to the proposed new security right or agree to limit the amount of the higher-ranking claim they will assert to a fixed amount (see paras. 128-131 below and recommendation 94). The higher-ranking secured creditors may be willing to subordinate their security rights or limit the amount of their higher-ranking claims because they believe that the proposed new extension of credit will help the grantor's business, thereby enhancing the likelihood that their higher-ranking claims will be paid. These examples illustrate why clear and well-conceived priority rules facilitate the granting of multiple security rights in the same assets, thereby enabling a grantor to maximize the value of its assets that can be used to obtain credit.

3. *Approaches to drafting priority rules*

20. States face a number of key policy choices when drafting priority rules. Initially, they must determine the scope of the priority regime. The first question is whether it should cover only competitions between various creditors of personal obligations or embrace competitions between all persons that claim rights in or in relation to a grantor's assets or ostensible assets. For reasons already given (see paras. 1-9 above), the *Guide* adopts the position that the priority regime should encompass priority competitions among all potential competing claimants that derive their rights from the same grantor.

21. States must then decide how these priority rules should be organized and drafted. Several approaches are possible, although they broadly reflect alternative tendencies in legislative drafting.

22. One approach is to develop priority rules as a set of general principles for courts to interpret and apply to resolve particular conflicts. When States adopt such an approach, especially in conjunction with the enactment of a new secured transactions regime of the fully integrated type that is recommended in the *Guide*, a tremendous burden is placed upon courts to flesh out the detailed application of these general principles. Not only must judges quickly master the underlying logic of the new regime, they must also ascertain and internalize a wide variety of market practices so as to develop specific rules that are predictable and efficient. Moreover, there may be a considerable period of time before a sufficient number of judicial decisions on a sufficient range of issues has been rendered so as to provide real certainty as to the operation of the priority principles in practice.

23. Another approach is to develop a large number of detailed priority rules meant to govern all the possible situations involving competing claimants that can be imagined. This detailed approach can sometimes lead to confusion among lawyers and judges who are not familiar with the overarching logic that these rules reflect. Moreover, in States that

already have priority regimes based on broad principles derived from first determining ownership of assets subject to competing claims, a comprehensive system of specific rules can look unfamiliar and unnecessarily complex and prove difficult for lawyers and judges to use efficiently.

24. A third approach is to develop and organize priority rules in a coherent whole as a series of more general principles followed by specific applications of these principles to commonly occurring situations. Such an approach can provide both clarity and a high degree of certainty about any individual priority conflict.

25. In selecting one or the other of these three approaches, a State must consider the overall objectives it is seeking to achieve in reforming its law as recommended in the *Guide*. To recall, the *Guide* aims to present a regime of secured transactions that envisions non-possessory security rights over a range of tangible and intangible assets that in many States could not previously be encumbered or have not been capable of being encumbered by more than one security right at a time (see recommendation 2, subparagraph (a)). Moreover, the *Guide* recommends that these assets may be subjected to more than one security right, a circumstance that is also novel in many States (see subparagraph (b) of the paragraph outlining the purpose of the recommendations on priority at the end of this chapter). The *Guide* also takes a fully integrated approach to transactions that, regardless of their name, are intended to secure the performance of an obligation (see recommendation 8). Finally, the *Guide* recognizes a variety of methods by which security rights may be made effective against third parties (see recommendations 32 and 34-36). For all these reasons, the *Guide* recommends that, in order to achieve best the objectives of reforming secured transactions law, States adopt the third approach to drafting their priority rules.

26. Following this logic, a modern secured transactions regime should incorporate a set of detailed and precise priority rules that: (a) rest on clearly expressed and well-understood general principles; (b) are comprehensive in scope; (c) cover a broad range of existing and future secured obligations; (d) apply to all types of encumbered asset, including future assets and proceeds; and (e) provide ways for resolving priority conflicts among a wide variety of competing claimants. Such an approach to priority rules encourages prospective creditors to extend secured credit by giving them a high degree of assurance that they are able to predict how potential priority disputes will be resolved. The remaining sections of this chapter specify what issues these detailed rules should address and how they should be formulated.

4. *Different foundations upon which priority may be determined*

27. In modern secured transactions regimes, priority rules are meant to govern competitions involving the rights of the holder of a security right and the rights of one or more third parties. A basic rule is the general principle that a security right cannot have priority over the right of a third party unless the security right is “effective” as against that third party. This is the position recommended in the *Guide*. Only in such cases can a question of priority arise. As a consequence, the priority rules recommended in the *Guide* are closely correlated with the different methods through which third-party effectiveness of the security right may be achieved.

28. As already noted (see chapter III on the effectiveness of a security right against third parties, paras. 6-8 and paras. 22-28), third-party effectiveness may be achieved when a security right has been created, depending on the type of asset being encumbered, and one of the following additional steps has taken place: (a) registration of a notice in the general security rights registry; (b) possession of the encumbered asset by the secured creditor; (c) conclusion of a control agreement; (d) registration of the security right in a specialized registry or its notation on a title certificate; and (e) notification to a third-party obligor. The *Guide* also contemplates that, in certain cases, third-party effectiveness of a security right may be achieved automatically upon creation of the security right.

(a) *Underlying policies*

29. Before undertaking a detailed review of how various priority principles apply to the rights of different competing claimants, it is helpful to set out in general terms the policy options available to States seeking to develop priority rules. Most States organize priority rules by combining two principles. The first principle is that priority should be determined strictly on a temporal basis. The second principle is that priority should be determined by reference to particular features of the claim being asserted. While these principles appear to be relatively straightforward, their application in practice calls for careful elaboration.

30. Normally, when a State adopts a temporal basis for determining priority, the foundational rule that it announces is that claims rank according to the date they become effective against third parties: first in time, first in right (*prior tempore, potior jure*). However, such a State may also recognize exceptions to this rule. In some situations, the last claim to arise may be given first priority. Such a rule exists in some States, for example, with respect to financing provided to a debtor during its insolvency proceedings (post-commencement financing). Thus, even where States adopt a temporal basis for determining priority, it is necessary to specify whether the ranking is to follow a first-in-time or a last-in-time rule.

31. When States decide to fix priority by reference to various features of a claim, an even greater range of possibilities arises. The question is whether priority should be based on: (a) a legislative ranking that focuses on the character of the claim (for example, a term loan, a line of credit or a claim arising from a wrongful act); (b) the character of the claimant (for example, a seller, a repairer or a municipality); (c) the amount of the obligation due (small claims, medium claims, large claims); (d) the percentage of the obligation outstanding (for example, less than 25 per cent, 25-50 per cent or more than 50 per cent); or (e) the manner in which third-party effectiveness is achieved (for example, registration in a general security rights registry, possession, registration in a specialized registry or control). In other words, when States determine priority by these types of subjective criterion, the ranking system becomes complex and many of the efficiencies of a secured transactions regime grounded in first-in-time rules are lost.

32. The point of reviewing the different bases for determining priority is twofold: (a) to provide a basic context for a brief examination of how these different overarching priority principles may apply depending on the method by which third-party effectiveness has been achieved; and (b) to foreshadow that States invariably establish priority rules that involve some combination of rules based on temporality and rules based on the nature of the claim,

even where the method of achieving third-party effectiveness (notably registration) seems to lend itself to the adoption of an absolute first-in-time priority rule.

(b) Application of these policies to different methods for achieving third-party effectiveness

33. As already discussed (see chapter III on the effectiveness of, a security right against third parties, para. 23, and chapter IV on the registry system, para. 3), the most effective way to provide creditors with the means to determine their priority with a high degree of certainty at the time they extend credit is to base priority on the use of a public registry. In most States in which a reliable system for registration of notices with respect to security rights exists, the general principle is that priority is accorded to the right referred to in the earliest-registered notice.

34. The first-to-register rule cannot, however, be absolute. In modern secured transactions regimes, there are specific exceptions to this rule. Sometimes States provide that a security right may become effective against third parties upon its creation without the need to register a notice. This exception is most often found in respect of security rights in consumer goods. In these cases, the priority of the security right is determined by reference to the time of its creation (see para. 38 below). In addition, some States provide for a grace period within which certain types of security right may be registered with retroactive effect (see, generally, para. 50 below, and chapter IX on acquisition financing, paras. 108-111). Finally, many States have adopted an exception to the first-to-register priority rule for security rights that have been made effective against third parties by a method other than registration of a notice in the general security rights registry (see paras. 35-37 below).

35. Where third-party effectiveness may be achieved through possession by the secured creditor, States also generally adopt a temporal rule for determining priority. The first to obtain possession has priority (see paras. 51-53 below). Nonetheless, in the case of certain assets such as negotiable instruments, many States provide that a security right that becomes effective against third parties by possession generally has priority over a security right made effective against third parties by any other method, including by registration of a notice even if the registration occurs first (see paras. 154-156 below).

36. Where third-party effectiveness may be achieved by means of control, priority as between creditors that have obtained control with respect to the encumbered asset and secured creditors that have obtained third-party effectiveness by any other method is typically accorded to the creditor that obtains control, regardless of whether that occurs before or after the rights of competing claimants in the asset are made effective against third parties by a different method (see para. 158 below). In States that provide that control is the exclusive method for achieving third-party effectiveness, however, there is no need to develop supplementary priority rules since conflicts between security rights whose third-party effectiveness is based on control and security rights whose third-party effectiveness is achieved by any other means cannot arise (see paras. 165 and 166 below).

37. Where third-party effectiveness may be achieved by registration in a specialized title registry for certain types of asset or by notation on a title certificate, most States provide that rights rank in the order in which they are registered or noted. These States also typically

provide that a right registered in the specialized registry or noted on a title certificate will have priority over a security right made effective against third parties by any other method (see paras. 56 and 57 below).

38. In States that have adopted registration systems, third-party effectiveness of security rights in certain types of asset, such as consumer goods, is sometimes automatic. In these States, the priority of a security right is usually determined by comparing the time when the security right is created with the time a notice with respect to the competing security right is registered in the general security rights registry or the competing security right has been made effective against third parties by some other method.

39. Where security rights are created in receivables or other rights to payment, States typically provide that priority will be determined according to the date on which a notice is registered in the general security rights registry or, if some other method for achieving third-party effectiveness is at issue, the date on which third-party effectiveness is achieved. In other States, however, third-party effectiveness of a security right in a receivable and priority among competing claimants with security rights in a receivable is based on the time that the debtor of the receivable is notified of the existence of the security right or even on the time of the creation of the security right. The general method for achieving third-party effectiveness recommended in the *Guide* also applies to security rights in receivables (see recommendation 32 and chapter III on the effectiveness of a security right against third parties, paras. 29-46). Thus, the priority of security rights in receivables is determined by the order of registration of a notice with respect to these rights (see section A.5 below).

40. In many States, certain claims, for example, claims for taxes and contributions to social welfare programmes and employee wages, are given a priority solely on the basis of the nature of the claim, regardless of the date on which the claim arose or was made effective against third parties. In these cases, States enact a ranking of priorities that is applicable to all competitions between claimants. Sometimes these rights also require registration, but sometimes they do not. In either case, however, priority is determined according to a legislatively established ranking and not according to the order in which the security right may have been created or made effective against third parties (see paras. 90-93 below).

41. The above review of how policies relating to the basis for determining priority apply to different methods for achieving third-party effectiveness reveals that, in each case, the regime adopted in most States involves a combination of priority principles based on time and priority principles based either on the specific character of a creditor's claim or on the specific method for achieving third-party effectiveness. In the next section, the application of these principles to different priority conflicts between competing claimants will be discussed in detail.

5. *Rules for determining priority as among competing claimants*

42. The general principles reviewed above form the basic structure of a priority regime in relation to: (a) the different means by which a priority system can be organized; and (b) the scope of the priority of the security right, in particular as this relates to future obligations, future assets and proceeds. The discussion that follows focuses on the specific priority rules to govern the rights of competing claimants. These priority rules will apply to govern

priority competitions in relation to all assets, including tangible assets such as equipment, inventory and receivables.

(a) Priority as among secured and unsecured creditors

43. Typically, States provide that all security rights that have been made effective against third parties have priority over the rights of unsecured creditors. It is generally accepted that giving secured creditors this priority is necessary to promote the availability of secured credit. Unsecured creditors can take other steps to protect their rights, such as charging a premium to account for their increased risk, monitoring the status of the credit or requiring the debtor to pay interest on amounts that are past due. In addition, secured credit can increase the working capital of the grantor. Often, payments made under a secured revolving working capital loan facility are the principal source from which a company will pay its unsecured creditors in the ordinary course of its business.

44. In many States, the priority afforded to secured creditors over unsecured creditors is absolute. In some States, however, it is subject to an exception in favour of judgement creditors. The holder of an unsecured claim may acquire a right in the assets of a debtor by obtaining a judgement or provisional court order against the debtor. By registering the judgement in the general security rights registry, the judgement creditor is able to convert an unsecured claim into a secured claim that ranks according to the ordinary priority rules. Other States go further and provide that, where an unsecured creditor has taken the steps required under applicable law to obtain a judgement or provisional court order, the property right it asserts may actually have priority over certain claims of a pre-existing secured creditor (see paras. 94-102 below).

(b) Priority as among competing security rights in the same encumbered assets

45. One of the key features of a modern secured transactions regime is the efficiency with which it resolves priority disputes among competing security rights in the same encumbered assets. Such priority disputes may involve security rights that are all made effective against third parties by registration of a notice in the general security rights registry, security rights that are all made effective against third parties by another method, or a combination of security rights that are made effective against third parties by registration and security rights that are made effective against third parties by another method. With very few exceptions (see paras. 54-59 below), States provide, for all the various situations about to be reviewed, that priority will be determined on a temporal basis: first in time, first in right. Moreover, States almost always prescribe achieving third-party effectiveness as the basic criterion for fixing the point in time that a security right is capable of entering into a priority competition. The following paragraphs explain in detail how this central principle is usually applied in specific situations.

(i) Priority as among security rights made effective by registration of a notice in the general security rights registry

46. In many States that have a general security rights registry, priority among security rights that were all made effective against third parties by registration of a notice is

determined by the order in which third-party effectiveness was achieved. That is, even if these States permit registration of a notice of a security right before the right actually comes into existence (for example, a security right taken exclusively over future movable assets), priority will be fixed by reference to the date when the grantor acquires rights in the asset and the security right thereby becomes effective against third parties. This approach has a major disadvantage for modern commercial financing practices. It would require searchers of the registry to determine when each asset covered by the registered notice was actually acquired (as in the case of inventory or equipment). As a result, most States that have adopted registration of a notice in a general security rights registry as a method of obtaining third-party effectiveness take a different approach, which constitutes a major exception to the basic principle of fixing priority by reference to the date of third-party effectiveness. These States provide that priority among security rights that were all made effective against third parties by registration of a notice is determined by the order in which registration occurs, regardless of the order of third-party effectiveness and even if one or more of the requirements for third-party effectiveness were not satisfied at that time. Only very limited exceptions to this principle are recognized (see para. 59 below).

47. This approach is illustrated by the following example. A grantor applies to bank A for a loan, to be secured by a security right in all of the grantor's existing and future equipment (a security right that may be made effective against third parties by registration of a notice in the general security rights registry). On day 1, bank A conducts a search of the registry, which confirms that no other notices have been filed with respect to security rights of other creditors in the grantor's equipment. On day 2, bank A enters into a security agreement with the grantor, in which bank A commits to make the requested secured loan. Also on day 2, bank A registers a notice of the security right in the general security rights registry, but does not make the loan to the grantor until day 5. Thus, the security right of bank A was created and became effective against third parties on day 2 (that is, the first time when all of the requirements for creation and third-party effectiveness were satisfied). However, on day 3, the grantor enters into a security agreement with bank B, providing for a loan to be made by bank B to the grantor to be secured by a security right in the grantor's existing and future equipment. On the same day (day 3), bank B registers a notice of the security right in the general security rights registry and grants the loan to the grantor. As a result, the security right of bank B was created and made effective against third parties on day 3. Under the first-to-register approach described above, bank A's security right would have priority over bank B's security right, regardless of the fact that bank B's security right was created and made effective against third parties before bank A's security right was created and made effective against third parties.

48. The primary reasons for the first-to-register exception to the general principle of fixing priority by reference to the date of third-party effectiveness are to: (a) encourage registration of the notice as early as possible (which puts other potential creditors on notice that a security right might already encumber the grantor's assets); (b) facilitate the extension of credit secured by future assets by providing a single date for establishing priority; and (c) provide certainty to secured creditors by enabling them to determine, before they extend credit, the priority of their security rights as against the rights of other secured creditors. In the above-mentioned example, if bank A searches the registry on day 2 after it registers its notice and determines that there are no other notices in the registry that cover the relevant encumbered asset, bank A can make its loan on day 5 knowing with certainty that its security right will have priority over any other security right in the

encumbered asset that may be made effective against third parties in the future, because the priority of bank A's security right dates back to the time of its registration. By enabling bank A to achieve this high level of certainty, the first-to-register approach can be a significant factor in promoting secured credit. Likewise, when bank B searches the registry it will immediately know that it will have a subordinate position should bank A extend credit and, consequently, it will be able to adjust the terms and conditions of the credit it extends accordingly.

49. As noted in the preceding paragraph, this certainty would not exist under the alternative approach adopted in some States, which accords priority to the first security right to become effective against third parties. There would always be a risk that another security right could achieve third-party effectiveness, and thus priority, after bank A or B conducts its search of the record but before it enters into a security agreement and makes its loan. This risk would exist regardless of how short that time period might be. For this reason, the *Guide* recommends that the priority of competing claimants in such cases should be determined by the date of registration of the notice and not the date that the security right was either created or actually became effective as against third parties (see recommendation 76, subparagraph (a)).

50. Finally, where priority is based on the first-to-register rule, that rule is, nonetheless, attenuated in many States to accommodate what have been called "grace periods" for registration. Grace periods permit retroactivity in the third-party effectiveness of a security right if registration takes place within a short period of time following the creation of a security right. In these cases, priority will be determined according to the date of creation rather than the date of registration. As a result, a security right that is created first but registered second may nevertheless have priority over a security right that is created second but registered first, as long as the notice with respect to the earlier-created security right is registered within the applicable grace period. Until the grace period expires, therefore, the registration date is not a reliable measure of a creditor's priority ranking. In order to avoid undermining the certainty achieved by the first-to-register rule, States generally restrict the use of grace periods to special circumstances, such as acquisition financing (see, generally, chapter IX on acquisition financing, paras. 108-111).

(ii) Priority as among security rights made effective against third parties by means other than registration of a notice in the general security rights registry

51. In the case of a priority dispute among security rights made effective against third parties by means other than registration of a notice in the general security rights registry, States normally accord priority to the security right that is first made effective against third parties. These other methods include possession, registration in a specialized registry, notation on a title certificate, control and automatic third-party effectiveness. Because many States adopt specific priority rules to govern situations involving third-party effectiveness achieved by registration in a specialized registry, notation on a title certificate and control, the main circumstances where this approach actually applies by virtue of general rules involve third-party effectiveness resulting from possession.

52. In the case of security rights achieving third-party effectiveness by possession, there is normally no need for a "first-to-obtain-possession" rule analogous to the "first-to-register"

rule noted above, as typically a secured creditor would obtain possession of the encumbered asset at the same time as it extends credit and not before. In some States, however, it is possible for a creditor to establish its possession through a third party acting on behalf of the secured creditor. Where this is the case, more than one secured creditor may establish possession through the same third party in such a manner. While it would be possible to determine their relative priority by reference to the order in which they establish their possession through that third party, this could create uncertainty if the security right has not yet been created. For this reason, where third-party effectiveness is achieved by possession, States usually provide that the relevant date for determining priority is the date of third-party effectiveness (that is, creation plus possession). A similar result would be reached in cases of automatic third-party effectiveness. Priority would depend on the date on which third-party effectiveness was established, although it so happens that in the case of automatic third-party effectiveness this would be the same date that the security right became effective between the parties (that is, the date of creation of the security right).

53. This approach can be illustrated using the case of a competition where one security right in a particular encumbered asset was made effective against third parties by possession and another security right in the same asset was made effective automatically upon its creation. In this example, by contrast with the principle applicable to security rights made effective against third parties by registration of a notice in the general security rights registry, it would be necessary to determine the respective dates at which possession was obtained or automatic third-party effectiveness was achieved. As noted, this is the general approach to priority taken in most States in this circumstance, namely, to determine the priority of competing claimants by reference to the date that the security right became effective as against third parties. It is also the approach recommended in the *Guide* (see recommendation 76, subparagraph (b)).

(iii) *Priority as among security rights made effective against third parties by registration of a notice in the general security rights registry and security rights made effective against third parties by other means*

54. Some security rights may be made effective against third parties in more than one way. As a result, States must also provide for the case where the priority dispute is between a security right made effective against third parties by registration of a notice in the general security rights registry and a security right made effective against third parties by other means. As noted, States normally accord priority to the first security right to be made effective against third parties. But where States have adopted the exception in cases involving registration in a general security rights registry providing for priority dating from registration rather than third-party effectiveness (which is the position recommended in the *Guide*), they typically also provide that priority should be given to the first security right to be registered or made effective against third parties by another method, whichever occurs first. This approach represents a logical extension of the first-to-register rule, using the registry as a basis for enabling secured creditors to achieve a high level of certainty with respect to the priority of their security right. As the notice may be registered before the security right is created (an outcome not contemplated in respect of third-party effectiveness achieved by possession and not logically possible in respect of automatic third-party effectiveness upon creation), this approach also encourages the use of the registry for making security rights effective against third parties. Because generalized use of the

registry provides an objectively determinable date for fixing priority and thus leads to the most efficient outcome when third-party effectiveness is achieved by different means, the *Guide* recommends this approach (see recommendation 76, subparagraph (c)).

(iv) *Exceptions to the first-in-time principle for establishing priority as among competing secured creditors*

55. The above-mentioned examples of how the first-in-time principle applies to the various situations where security rights are made effective against third parties by different means are nonetheless subject to limited exceptions. These exceptions are of two types. Some reflect special priority rules relating to specific means for achieving third-party effectiveness. Others reflect special rules relating to certain types of transaction or encumbered asset. Of the various means for achieving third-party effectiveness already mentioned, three in particular (that is, registration in a specialized registry, notation on a title certificate and control) often lead to special priority rules.

a. *Registration in a specialized registry or notation on a title certificate*

56. In many States, a security or other right (such as the right of a buyer or lessee of an encumbered asset) may be registered in a specialized registry or noted on a title certificate. Most of these States provide that security rights rank in the order in which they are registered or noted. That is, a registered or noted security right has priority over a subsequently registered or noted security right. In order to protect the integrity of specialized registries or notation systems, the *Guide* recommends a similar approach (see recommendation 77, subparagraph (b)).

57. When a specialized registry exists, it is also necessary to determine the priority as between a right registered in the specialized registry or noted on a title certificate, on the one hand, and a right registered in the general security rights registry or a right that has been made effective against third parties by possession or some other means, on the other hand. In most such States, a security right or other right registered in a specialized registry or noted on a title certificate is accorded priority over a security right registered in a general registry or that achieves third-party effectiveness by a method other than registration in a specialized registry or notation on a title certificate, regardless of which occurred first. Thus, for example, in these systems, if secured creditor A registers a notice in the general security rights registry or takes possession of an encumbered asset and later secured creditor B registers a security right in the specialized registry or makes a notation on the title certificate, secured creditor B will have priority over secured creditor A. Once again, in order to protect the integrity of such registries and notation systems, the *Guide* recommends a similar approach (see recommendation 77, subparagraph (a)).

b. *Control agreements*

58. A second exception is usually found in States that permit third-party effectiveness of security rights in certain types of intangible asset to be achieved by “control”. These States provide that, where a creditor obtains third-party effectiveness of a security right by

control, priority is given to that security right regardless of whether other creditors with a security right in the same encumbered asset may have previously registered a notice in the general security rights registry or achieved third-party effectiveness by any other means (see paras. 158 and 166 below). In view of the special nature of security rights in rights to payment, the *Guide* recommends a similar approach (see recommendations 103 and 107).

c. Other exceptions to the first-in-time rule

59. In addition to the situations where third-party effectiveness is achieved by special means, many States provide exceptions to the first-in-time rule for certain types of transaction or certain types of encumbered asset where third-party effectiveness has been achieved by registration or possession. The most common situations involve the following types of transaction or asset: (a) acquisition financing transactions (the *Guide* deals with these transactions in chapter IX on acquisition financing; see recommendations 178-185 and 191-199); (b) secured transactions involving security rights in negotiable instruments, negotiable documents or money, third-party effectiveness of which may be achieved by possession (see paras. 154-156, 164 and 167-169 below and recommendations 101, 102, 106, 108 and 109); (c) secured transactions involving security rights in attachments (see paras. 110-116 below and recommendations 87-89); and (d) secured transactions involving security rights in masses or products (see paras. 117-124 below and recommendations 90-92).

(c) Priority of rights of transferees, lessees and licensees of encumbered assets

(i) General

60. When a grantor transfers, leases or licenses tangible assets (other than negotiable instruments or negotiable documents) that are subject to existing security rights, the transferee, lessee or licensee has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets as against the transferee, lessee, or licensee (subject to certain exceptions; see paras. 65-88 below). It is important that priority rules address both of these interests and that an appropriate balance be struck. If the rights of a secured creditor in specific assets are put at risk every time its grantor transfers, leases or licenses them, their value as security would be severely diminished and the availability of secured credit based on their value would be jeopardized.

61. In most States, the starting point is the general principle that a transferee (including a buyer, exchanger, donee, legatee and other similar transferees), lessee or licensee of an encumbered asset takes its rights in the asset subject to an existing security right that is effective against third parties. The security right is said to encompass a right to follow the assets in the hands of a transferee, lessee or licensee (see chapter III on the effectiveness of a security right against third parties, paras. 15-18, and recommendation 31; see also recommendation 79). In other words, the secured creditor may follow the asset in the hands of the buyer or other transferee, lessee or licensee. It follows, therefore, that other third parties that derive their rights from the buyer or other transferee, lessee or licensee in such cases generally will also take their rights subject to the existing security right (see paras. 84-88 below). Exceptions to this general principle with respect to each of these types of transaction are discussed below.

(ii) *Rights of buyers*

62. As mentioned previously (see chapter II on the creation of a security right, paras. 72-89 and chapter III on the effectiveness of a security right against third parties, paras. 15-18 and 87-96), when an encumbered asset is sold, the secured creditor retains its security right in the original encumbered asset and also obtains a security right in the proceeds of the sale (which may include cash, receivables or even other assets in the case of transactions between barterers and exchangers). In this situation, a question arises as to whether the security right in proceeds should replace the security right in the encumbered asset, so that the buyer takes its rights free of the security right.

63. It is sometimes argued that the security right should be extinguished upon a sale, on the premise that the secured creditor is not harmed by a sale of the assets free of its security right so long as it retains a security right in the proceeds of the sale. However, this result would not necessarily protect the secured creditor, because proceeds are often not as valuable to the creditor as the original encumbered asset. In many instances, the proceeds may have little or no value to the creditor as security (for example, a receivable that cannot be collected because the debtor of the receivable is not financially sound). In other instances, it might be difficult or impossible for the creditor to identify the proceeds and its claim to the proceeds may, therefore, be illusory. In addition, there is a risk that the proceeds, even if they are of value to the secured creditor, may be dissipated by the seller that receives them, leaving the creditor with nothing. Finally, it may be that another creditor may have taken a security right in the proceeds as original encumbered assets and may have priority with respect to the proceeds. This possibility is especially real in the case of receivables, where it is not uncommon for a grantor to obtain inventory financing from one lender and receivables financing from another lender.

64. While States have adopted different approaches to achieving a balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession, most provide that the security right should survive the transfer even when the secured creditor is also able to claim a right in proceeds. This does not mean that the secured creditor will be paid twice. As a security right secures an obligation, the secured creditor that asserts rights in the assets and in the proceeds cannot claim or receive more than it is owed. The *Guide* recommends that, as a general principle, the secured creditor should retain its security right in the original encumbered asset and also a security right in the proceeds of its sale or other transfer (see recommendations 19, 31, 39, 40 and 79).

65. This said, most States recognize two exceptions to the general principle that a security right in an asset continues to encumber the asset after its sale, and the *Guide* does also. The first exception relates to situations in which the secured creditor expressly authorizes the sale free of the security right (see recommendation 80, subparagraph (a)). A secured creditor may authorize such a sale, for example, because it believes that the proceeds are sufficient to secure payment of the secured obligation or because the grantor gives the secured creditor other assets as security to make up for the loss of the sold asset. It should be noted, however, that this exception does not apply to situations in which the secured creditor authorizes the sale but does not authorize the grantor to sell free of the security right. In these situations, the buyer generally takes title to the asset subject to the security right.

66. The second exception refers to situations in which the authorization by the secured creditor to sell the assets free of the security right is inferred because the encumbered assets are of such a nature that the secured party expects them to be sold free of the security right, or where it is in the best interest of all concerned parties that they be sold free of the security right. States have framed this second exception in a number of different ways, as described in the following paragraphs.

a. The ordinary-course-of-business approach

67. A common approach, taken in many States, is to provide that sales of encumbered assets consisting of inventory made by the grantor in the ordinary course of its business will result in the automatic extinguishment of any security rights that the secured creditor has in the assets without any further action on the part of the buyer, seller or secured creditor. The corollary to this rule is that, when a sale of inventory is outside the ordinary course of the grantor's business, or when the sale relates to an asset other than inventory, the exception will not apply; such a sale does not extinguish the security right and the secured creditor may, upon default by the grantor, enforce its security right against the encumbered asset in the hands of the buyer (unless the secured creditor has authorized the sale free of the security right). Where the security agreement so provides, the sale itself may constitute a default entitling the secured creditor to enforce its security right; otherwise, the secured creditor cannot do so until default has occurred.

68. Under this approach, two requirements must be satisfied for the encumbered asset to be sold free of the security right. The first requirement is that the seller of the asset must be in the business of selling assets of that kind. The encumbered asset cannot be something that the seller does not typically sell. In addition, the sale cannot be concluded in a manner different than the manner typically followed by the seller, such as a sale by the seller outside of its typical distribution channel (for example, if the seller normally sells only to retailers and the sale at issue is to a wholesaler). The second requirement is that the buyer must not have knowledge that the sale violates the rights of a secured creditor under a security agreement. This would be the case, for example, if a buyer had knowledge that the sale to it was prohibited by the terms of the security agreement. On the other hand, mere knowledge on the part of the buyer of the fact that the asset was subject to a security right would be insufficient.

69. The ordinary-course-of-business approach has the advantage that it is consistent with the commercial expectation that the grantor will sell its inventory of tangible assets (and indeed must do so to remain financially viable) and that buyers of the tangible assets will take them free and clear of existing security rights. Without such an exception to the principle that the security right continues in the asset in the hands of a buyer, a grantor's ability to sell inventory in the ordinary course of its business would be greatly hampered, because buyers would have to investigate claims to the tangible assets prior to purchasing them. This situation would result in significant transaction costs and would greatly impede ordinary-course-of-business transactions.

70. The ordinary-course-of-business approach also provides a simple and transparent basis for determining whether inventory is sold free and clear of security rights. For example, the sale of equipment by an equipment dealer to a manufacturer that will use

the equipment in its factory is clearly a sale of inventory in the ordinary course of the dealer's business, and the buyer should automatically take the equipment free and clear of any security rights in favour of the dealer's creditors. This result is in line with the expectations of all parties and the buyer is certainly entitled to presume that both the seller and any secured creditor of the seller expect the sale to take place in order to generate sales revenue for the seller. Conversely, a sale by the dealer of a large number of machines in bulk to another dealer would presumably not be in the ordinary course of the dealer's business. Similarly, a sale by a printer of old printing presses would also not be in the ordinary course of the printer's business. In most cases, it will be obvious to the buyer or easy for the buyer to ascertain whether the sale is in the seller's ordinary course of business. For these reasons, the ordinary-course-of-business approach is the approach recommended in the *Guide* (see recommendation 81, subparagraph (a)).

71. With respect to sales that are obviously outside the ordinary course of the grantor's business or where there is at least a question in the mind of the buyer, as long as creditors' security rights are subject to registration in a general security rights registry, the buyer may protect itself by searching the registry to determine whether the asset it is purchasing is subject to a security right and, if so, seek a release of the security right from the secured creditor.

72. In some States, buyers of encumbered assets are permitted to take the assets free of the security right, even where the transaction is outside the ordinary course of the seller's business, if the assets are low-cost items. The reason given for this approach is that, in those jurisdictions, the secured transactions law either does not permit registration of a security right in a low-cost item or the cost of registration is high in relation to the cost of the asset and it would be unfair to impose that cost on a buyer of the item. By contrast, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in setting arbitrary limits, which would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors. For these reasons, the *Guide* does not recommend an additional exception for low-cost items.

73. One potential disadvantage of the ordinary-course-of-business approach, in particular in international trade, arises in those limited situations where it is not clear to a buyer what activities fall within the ordinary course of the seller's business. This said, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved and in these situations the ordinary-course-of-business approach would be consistent with the expectations of the parties. Therefore, the number of cases in which such confusion exists is limited in practice. On balance, the benefits of the ordinary-course-of-business approach outweigh its disadvantages. This approach facilitates commerce and allows secured creditors and buyers to protect their respective interests in an efficient and cost-effective manner without undermining the promotion of secured credit.

b. The good-faith approach

74. Many States have taken a different approach to determining whether a buyer of encumbered assets takes title to the assets free of a security right created by the seller. In

these States, a buyer of tangible assets takes them free of any security rights if the buyer purchases the assets in good faith (without regard to whether the sale was in the ordinary course of business of the seller). States have adopted various formulations of the definition of “good faith” for the purposes of this test. For example, in some States the buyer is under a duty to investigate whether the assets are subject to a security right, while in other States the buyer is not under such a duty.

75. One argument in favour of this approach is that good faith is a notion known to all legal systems and that there is significant experience with its application at both the national and international levels. Another argument is that there should be a presumption that a buyer is acting in good faith unless it is proven otherwise. A third argument in favour of this approach is that it relieves the buyer of the cost and time involved in conducting a search of the registry. However, the problem with such an approach is that it focuses on a subjective criterion relating to the knowledge and intentions of a buyer (which raises difficult evidentiary issues) rather than on the commercial expectations of parties involved in such transactions.

c. The time-limitation approach

76. Some States adopt a third approach to determining when a security right may be effective against a purchaser or other transferee of the grantor. In these States, the security right that encumbers the sold asset will cease to encumber the asset if the security right secures a credit advanced after the expiry of a certain period (for example, six months) from the time the right became effective against third parties or was registered. In this system, the transferee need not be in good faith or even acquire the asset in the ordinary course of business of the seller. The criterion for extinguishing the security right would be simply temporal. While this criterion appears to provide an objective date, it requires all purchasers, including those that are purchasing in the ordinary course of business of the seller or in good faith, to determine not only whether a security right exists but also the date on which the credit secured by the security right was extended. Such an approach raises very difficult evidentiary and practical issues and also does not accord with the normal expectations of buyers and sellers of tangible assets.

(iii) Rights of lessees

77. Priority disputes sometimes arise between the holder of a security right in a tangible asset granted by the owner/lessor of the asset, on the one hand, and a lessee of such asset, on the other hand. In this context, the issue is not whether the lessee actually takes the asset free of the security right in the sense that the security right is cut off. Rather, the issue is whether the lessee’s right to use the leased asset under the terms and conditions set forth in the lease agreement are unaffected by the security right. The key point is whether, once the holder of a security right granted by the owner or lessor commences enforcement, the lessee can nevertheless continue using the asset so long as it continues to pay rent and otherwise abides by the terms of the lease. The general principle discussed in relation to buyers applies here as well (see paras. 62-66 above). The asset is, in principle, subject to the security right and thus the secured creditor may enforce its security right upon default of the grantor/owner or grantor/lessor, even if this means interrupting the use of the asset by the lessee pursuant to the lease.

78. As in the case of buyers of tangible assets subject to a pre-existing security right, many States recognize two exceptions to this general principle. Under either exception, the security right does not cease to exist. However, for the duration of the lease, the right of the secured creditor is limited to the lessor-grantor's own rights in the assets and the lessee may continue to enjoy uninterrupted use of the asset in accordance with the terms of the lease.

79. The first exception is where the secured creditor has authorized the grantor to enter into the lease unaffected by the security right. As in the case of sales of tangible assets, where a secured creditor has authorized the lease, the lessee's knowledge of the security right is irrelevant. The *Guide* recommends this exception (see recommendation 80, subparagraph (b)). The second exception relates to situations in which the lessor of the tangible asset is in the business of leasing tangible assets of that type, the lease is entered into in the ordinary course of the lessor's business and the lessee has no actual knowledge that the lease violates the rights of the secured creditor under the security agreement. Such knowledge would exist if, for example, the lessee knew that the security agreement creating the security right specifically prohibited the grantor from leasing the assets. However, the mere knowledge of the existence of the security right, whether arising because the lessee saw a notice registered in the security registration system or in another way, would not be sufficient to defeat the rights of the lessee. This exception is based on similar policy considerations to those relating to the analogous exception for sales of tangible assets in the ordinary course of the seller's business and is the approach recommended in the *Guide* (see recommendation 81, subparagraph (b), and paras. 67-73 above).

(iv) *Rights of licensees*

80. The issues discussed above also arise in the context of licensing intangible assets that are subject to a security right created by the licensor and the general principle applicable to sales and leases of tangible assets also applies to licences of intangible assets (see recommendation 79). Thus, if a security right in an intangible asset is effective against third parties, it will continue in the asset in the hands of the licensee unless one of the exceptions mentioned below applies (see recommendations 80 and 81).

81. The first exception recognized by most States has two aspects, which track the rule in relation to sales and leases of tangible assets. Analogous to leases, where the secured creditor has authorized the licence, the licensee takes the licensed asset free of the security right and it is irrelevant whether the licensee knew of the security right. The *Guide* recommends this exception (see recommendation 80, subparagraph (b)).

82. The second exception (also analogous to similar exceptions for sales and leases of tangible assets) is a situation involving a non-exclusive licensing of intangible assets, where the licensor is in the business of granting non-exclusive licences of such assets, the licence is entered into in the ordinary course of the licensor's business and the licensee had no knowledge that the licence violated the rights of the secured creditor under the security agreement (see recommendation 81, subparagraph (c)). As in the case of sales and leases of tangible assets, it is generally recognized that such knowledge would exist if, for example, the licensee knew that the security agreement creating the security right specifically prohibited the grantor from licensing the assets. However, the mere knowledge of the existence of

the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the rights of the licensee. A typical example would be a non-exclusive licence granted to a consumer of a popular software program. Where the security agreement so provides, the granting of the licence itself may constitute a default entitling the secured creditor to enforce its security rights and seek collection of royalties from the licensee; otherwise, the secured creditor cannot do so until default has occurred. However, the fact that the non-exclusive licence constitutes a default will not affect the validity of the licence so long as the conditions of recommendation 81, subparagraph (c), are satisfied (in particular lack of knowledge by the non-exclusive licensee that the granting of the licence violates the security agreement between the licensor and its secured creditor).

83. It is important to note that this second exception relates only to non-exclusive licences of intangible assets (that is, licences under which the licensee is not the sole and exclusive licensee of the intellectual property covered by the licence), as is the case with mass-distributed software programs. Where a grantor is engaged in the business of licensing intangible assets, a secured creditor holding a security right in the assets normally will expect its grantor to grant non-exclusive licences of the assets in order to generate revenue. Moreover, it is not reasonable to expect the licensee under a non-exclusive licence to search the general security rights registry to ascertain the existence of security rights in the licensed assets. However, an exclusive licence of intangible assets, under which the licensee is granted the exclusive right to use the assets throughout the world or even in a specific territory, is generally a negotiated transaction. Such a transaction is often out of the ordinary course of the licensor's business, although it may also be in the ordinary course of the licensor's business if the licensor is in the business of negotiating exclusive licences, as is often the case, for example, in the motion picture industry. In the case of an exclusive licence, it is reasonable to expect the licensee to search the general security rights registry to determine if the licensed assets are subject to a security right created by the licensor and to obtain an appropriate waiver or subordination of priority where such a security right is found to exist.

(v) *Rights of remote transferees, lessees and licensees*

84. An effective secured transactions regime must also address various situations where an encumbered asset is sold, transferred, leased or licensed by a transferee, lessee or licensee more than once. A first type of situation involves transfers that are sales, none of which sales are undertaken in the ordinary course of business of the seller, made in good faith or within a certain period of time (see paras. 67-76 above). In some States, if the grantor of a security right sells an encumbered asset to a purchaser (the first purchaser), which then resells the asset to a second purchaser (the remote purchaser), the remote purchaser obtains the encumbered asset free of the security right created by the grantor. This approach is taken in these States, because it would be difficult for a remote purchaser to detect the existence of a security right granted by a person that owned the encumbered assets before the first purchase. In many instances, remote purchasers are not aware of the identity of the previous owner and, accordingly, have no ability to conduct a search against the name of the previous owner.

85. The problem with this approach, however, is that it impairs the reliability of a security right given by a grantor because of the possibility that the encumbered asset will be

sold without the secured creditor's knowledge to a first purchaser and then to a remote purchaser, either innocently or with the specific intention of stripping away the security right. For this reason, other States provide that the rights of the remote purchaser will depend on the rights of the seller from which the remote purchaser purchased the encumbered asset (that is, whether any of the sales have been made in the ordinary course of the seller's business or in good faith or within a certain period of time). Thus, for example, if the remote purchaser buys from a seller that purchased the asset subject to the security right, the remote purchaser will also acquire the asset subject to the security right. Conversely, in these States, if the remote purchaser buys from a seller that purchased the encumbered asset free of the security right, the remote purchaser will acquire the asset free of the security right.

86. A second type of situation arises where the security right follows the encumbered asset after the sale to the first purchaser, but the asset is then re-sold by the first purchaser to the remote purchaser in the ordinary course of the first purchaser's business (or in good faith or within a certain period of time). In these cases, it is necessary to determine which security rights are affected by the ordinary course of business principle. Two approaches are possible. Some States provide that the ordinary-course-of-business sale (or a sale in good faith or within a certain time period) only enables the remote purchaser to acquire free of security rights granted by the first purchaser. Other States provide that the remote purchaser acquires the asset free of all security rights, including those granted by the initial seller.

87. To promote the policy of the ordinary-course-of-business approach, the *Guide* recommends that, where a buyer of encumbered assets takes the assets free of a security right granted by its seller, a remote purchaser will also take the assets free of that security right (see recommendation 82). If the seller takes the assets subject to the security right, the remote purchaser will also normally take them subject to that right (*a contrario*). Nonetheless, to relieve the remote purchaser of the need to inquire into the history of the asset when it has been acquired in the ordinary course of the initial seller's business, the *Guide* accepts that the remote purchaser in such cases will take free of all security rights encumbering the asset, including security rights that may have been granted by the initial seller. This result is derived from reading recommendation 79, which allows exceptions, together with recommendation 81, subparagraph (a), which is not limited to security rights granted by the immediate seller of the encumbered asset. Requiring a person (including a consumer) that purchases an encumbered asset in the ordinary course of business to go back up the chain of title would be an impediment to commerce. A remote financier has an unlimited proceeds right in any event, while an ultimate purchaser normally has neither the resources nor the time to investigate a remote chain of title and buys from a dealer (rather than a private person) precisely to avoid having to do a search of the chain of title.

88. A similar set of considerations applies in cases involving a series of leases and sub-leases. So, for example, in situations in which the rights of a lessee of a tangible asset are deemed to be unaffected by a security right in the assets granted by the lessor, it is generally considered appropriate that the rights of a sub-lessee will also be unaffected. Finally, as in the case of sales and leases of encumbered assets, a strong argument exists in favour of ensuring that a sub-licensee is unaffected by a security right created by the original licensor in those situations where the law deems the licence itself to be unaffected by the

security right. To maintain consistency of approach in relation to ordinary-course-of-business transactions, the *Guide* recommends that sub-lessees or sub-licensees take free of a security right in all cases where the initial lessee or licensee takes free of that right (see recommendation 82).

(vi) *Rights of donees and other gratuitous transferees*

89. The position of a recipient of an encumbered asset as a gift (typically a donee but also a legatee) is somewhat different from that of a buyer or other transferee for value. As the gratuitous transferee has not parted with value, there is no objective evidence that the transferee has relied to its detriment on the grantor's apparently unencumbered ownership. As a result, in a priority dispute between the donee of an asset and the holder of a security right in the asset granted by the transferor, a strong argument exists in favour of awarding priority to the secured creditor, even in circumstances where the security right was not otherwise effective against third parties. A second argument in favour of this approach is that, where an encumbered asset is the subject of a gift, there are no proceeds to which the secured creditor may look as substitute encumbered assets. While some States take this approach, most States follow the general rule that only security rights that have been made effective against third parties will have priority over other claimants. This means that a security right that is effective against third parties follows the asset in the hands of a transferee (see recommendation 79) and exceptions are made only for transferees for value, such as buyers and other persons that acquire rights from the grantor for value such as lessees or licensees (see recommendations 80-82). Applying this rule, a donee could never be a transferee in the ordinary course of business and would take an encumbered asset subject to the security right, unless the security right were not effective against third parties.

(d) *Priority of preferential claims*

90. In many States, as a means of achieving general social goals, certain unsecured claims are re-characterized as preferential claims and given priority within or even outside insolvency proceedings over other unsecured claims. In some cases, the priority also extends to secured claims, including secured claims that had become effective against third parties by registration or otherwise before the unsecured claims arose. For example, in some States the claims of employees for unpaid wages and of the State for unpaid taxes are given priority over previously existing security rights. As social goals differ from jurisdiction to jurisdiction, the precise nature of these claims and the extent to which they are afforded priority are quite variable. Moreover, in many States, at least some of these claims must be registered in order to be effective against third parties, while other States do not require registration for third-party effectiveness. In States that do not require registration, the preferential claim normally is not vested with a right to follow. Consequently, it cannot be set up against transferees (even gratuitous transferees) of the asset encumbered by the preferential claim.

91. The advantage of establishing these preferential claims is that a social goal may be furthered. The possible disadvantage depends, in large part, on whether the claims are required to be registered. The disadvantage of unregistered preferential claims is that it

will typically be difficult or impossible for prospective creditors to know whether such claims exist, a circumstance that is likely to increase uncertainty and thereby discourage secured credit. This particular disadvantage does not affect claims that have to be registered. Nonetheless, even registered preferential claims can adversely affect the availability and cost of secured credit when they are given priority over pre-registered security rights. The reason is that, as such claims diminish the economic value of an asset to a secured creditor, creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate or by withholding the estimated amount of such claims from the available credit.

92. To avoid discouraging secured credit, many States have recently cut back on the number of preferential claims that are given priority over existing security rights. The trend in modern legislation is to establish such claims only when there is no other effective means of satisfying the underlying social objective. For example, in some jurisdictions tax revenue is protected through incentives for company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund. In addition, many States have also sought to limit the impact of preferential claims on the availability of secured credit by imposing a cap either on the amount that may be paid to the preferred claimant or on the percentage of the amount realized upon enforcement that may be used to pay them.

93. If preferential claims are permitted to exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims in advance and to protect itself. Some States have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other States have achieved this result by requiring that preferential claims be registered in a public registry and by according priority to such claims only over security rights registered thereafter. When States adopt this second approach, however, much of the rationale for preferential claims disappears. This is because a number of these claims arise immediately prior to insolvency proceedings and, therefore, there is unlikely to be any secured credit arising after they are registered (unless there is a need for secured post-commencement finance). The *Guide* seeks to achieve a balance with respect to preferential claims. It does not recommend their registration, although such registration would be possible. The *Guide* rather recommends that the law should limit such claims, both in type and amount, and that, to the extent preferential claims exist, they should be described in the law in a manner that is sufficiently clear and specific to enable prospective secured creditors to evaluate whether or not to extend credit to a grantor (see recommendation 83).

(e) Priority of rights of judgement creditors

94. In contemporary secured transactions regimes, the general rule is that a security right that is effective against third parties is accorded priority over the rights of an unsecured creditor. However, in some States the holder of an unsecured claim may obtain a right in the assets of a debtor by obtaining a judgement or provisional court order against the debtor and by registering the judgement or provisional court order in the general security rights registry. Doing so has the effect of converting an unsecured claim into a secured claim that ranks according to the ordinary priority rules. Some of these States go further and provide that, where an unsecured creditor has taken the steps required

under applicable law to obtain a judgement or provisional court order, the property rights it thereby obtains may actually have priority over certain claims of a pre-existing secured creditor. The law distinguishes these creditors from other unsecured creditors because of their diligence in doing whatever they could do, often at significant cost, to pursue their claim against their obligor. For ease of reference, the term “judgement” is used in the following discussion to refer to both a judgement and a provisional court order and the term “judgement creditor” is used to refer to a creditor that has obtained either a judgement or a provisional court order against a debtor.

95. This result is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement but have not taken the time or incurred the expense to do so. However, to avoid giving judgement creditors excessive powers, especially in those legal systems where a single creditor may institute insolvency proceedings, some insolvency laws provide that security rights arising from judgements obtained within a specified period of time prior to the insolvency proceedings may be avoided by the insolvency representative, in which case the judgement creditor’s property right is extinguished or not recognized in the debtor’s insolvency proceedings.

96. Modern secured transactions regimes typically address this type of priority dispute by balancing the interests of the judgement creditor and the secured creditor. On the one hand, the judgement creditor has an interest in knowing at a given point in time whether there is sufficient value left unencumbered in the grantor’s assets to warrant continued enforcement of the judgement. On the other hand, a strong policy argument exists in favour of protecting the rights of the secured creditor, on the ground that the secured creditor expressly relied on its security right as a basis for extending credit.

97. Many States seek to achieve this balance by generally giving priority to a security right over a property right of a judgement creditor in encumbered assets, so long as the security right became effective against third parties before the judgement creditor’s property right arises. This is the general principle adopted in the *Guide* (see recommendation 84).

98. In States that seek to protect the rights of judgement creditors, there is typically one exception and two limitations to the general principle just set out. Commonly, an exception to the rights of judgement creditors is created in the case of acquisition security rights in encumbered assets other than inventory or consumer goods. Priority is accorded to the acquisition security right even if it is not effective at the time the judgement creditor obtains rights in the encumbered assets, so long as the security right is made effective against third parties within the applicable grace period provided for such security rights. A contrary result would create an unacceptable risk for providers of acquisition financing that had already extended credit prior to the time when the judgement creditor obtained its property right and thus would discourage acquisition financing (see recommendation 183).

99. The two limitations to the rule mentioned above relate to restrictions on the extent of the priority of a security right (that is, the amount of credit given priority) over the rights of a judgement creditor. The first limitation arises from the need to protect existing secured creditors from extending additional amounts of credit based on the value of

assets subject to judgement rights. There should be a mechanism to put creditors on notice of the judgement rights. In many jurisdictions in which there is a registration system, this notice is provided by subjecting judgement rights to the registration system. If there is no registration system, or if judgement rights are not subject to the registration system, the judgement creditor might be required to notify the existing secured creditors of the existence of the judgement. In addition, the law may provide that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement right is registered (or after the creditor receives notice of the judgement creditor's right in the encumbered assets), so that the creditor can take steps to protect its rights accordingly. The less time an existing secured creditor has to react to the existence of judgement rights and the less public such judgement rights are made, the more their potential existence will negatively affect the availability and cost of credit, especially in the context of revolving credit transactions that provide for extension of credit at various times after the conclusion of the credit agreement (see, for example, Introduction, para. 30).

100. With respect to a security right for which a notice has been registered, the *Guide* recommends that the secured creditor should be notified of the existence of the judgement creditor's right and that the priority of any security right is limited to credit extended by the secured creditor prior to and for a limited number of days (such as 30-60) after the secured creditor had been notified (see recommendation 84, subparagraph (a)). Although this limitation imposes an obligation on the judgement creditor to notify the secured creditor, that obligation is generally not overly burdensome for the judgement creditor and relieves the secured creditor of the obligation to search frequently for judgements against the grantor, which would be a far more burdensome and costly obligation. The existence of the grace period is justified on the ground that it prevents the secured creditor under a revolving loan facility or other credit facility providing for future extensions of credit from having to cut off loans or other credit immediately, a circumstance that could create difficulties for a grantor or even force the grantor into insolvency proceedings.

101. The second limitation relates to commitments to extend credit in the future. The priority of a security right may be extended to credit provided even after the secured creditor is notified of the judgement creditor's rights, provided the credit was irrevocably committed, prior to that notice, in a fixed amount or an amount that may be determined pursuant to a specified formula.

102. The rationale for this rule is that it would be unfair to deprive a secured creditor that has irrevocably committed to extend credit of the priority that it relied on when making the commitment. The contrary argument is that, under many credit facilities, the existence of a judgement would constitute an event of default, entitling the secured creditor to cease extending additional credit. However, ceasing to extend credit may not be a sufficient protection for the secured creditor and may be harmful to other parties as well. For example, the sudden loss of credit precipitated by the judgement could well force the grantor into insolvency proceedings, resulting not only in loss to the secured creditor and other creditors but also the possible destruction of the grantor's business. The *Guide* resolves this priority dispute in favour of the continued extension of credit under an irrevocable commitment, in the interest of allowing the grantor to remain in business (see recommendation 84, subparagraph (b)).

(f) *Priority of rights of persons providing services with respect to an encumbered asset*

103. In many States, creditors that have provided services with respect to, or have added value to, tangible encumbered assets in some way, such as by storing, repairing or transporting them, are given a property right in the assets. In some States, this right can ripen into a property right that permits the service provider to enforce its claim as if it were a security right. In other States, this right is simply a right to refuse to hand over the assets to the owner, a secured creditor of the owner or anyone else seeking their delivery. Regardless of the nature of the service provider's right, in these States the right may only be claimed while the encumbered assets are still in the possession of the service provider.

104. This treatment of service providers has the advantage of inducing them to continue providing services and of facilitating the maintenance and preservation of encumbered assets. In most States the right given to service providers has priority over all other rights that may be claimed in assets in their possession. In particular, this right ranks ahead of any other security right in those assets, regardless of the respective dates on which the two rights became effective against third parties. The rationale underlying this priority rule is that service providers are not professional financiers and should be relieved of searching the registry to determine the existence of competing security rights before providing services. Moreover, the rule facilitates services such as storage and repairs and other improvements that typically benefit secured creditors as well as grantors.

105. A question arises as to whether the priority given to service providers should be limited in amount or recognized only in certain circumstances. One approach is to limit priority to an amount (such as one month's rent in the case of landlords) and to recognize the priority of these rights over pre-existing security rights only where value is added that directly benefits the holders of the pre-existing security rights. This approach would have the advantage that the rights of secured creditors would not be unduly limited. It would have the disadvantage, however, that service providers that did not add value or could not show that their services had added value (for example, storage services) would not be protected. In addition, the amount of the value added by the service providers would need to be determined. This requirement may add costs and create litigation.

106. Another approach is to limit the priority of service providers to the reasonable value of services provided. Such an approach would reflect a fair and efficient balance between the conflicting interests. It would ensure reasonable protection of service providers, while avoiding difficult questions of proof as to the relative value of the encumbered assets before and after the services are rendered. As the reasonable value of services is based on a calculation that can be verified comparatively and publicly, this approach also minimizes the costs associated with claiming the right. For this reason, it is the approach recommended in the *Guide* (see recommendation 85).

(g) *Priority of a supplier's reclamation right*

107. In some States, a supplier selling tangible assets on unsecured credit may, upon the buyer's default or general inability to pay its debts, be given by law a right to reclaim the tangible assets from the buyer within a specified period of time. This right is usually known as a "reclamation right" and the specified period is known as the

“reclamation period”. This reclamation right may arise both within and outside insolvency. If insolvency proceedings have commenced with respect to the buyer, applicable insolvency law will determine the extent to which the rights of reclamation claimants would be stayed or otherwise affected (see recommendations 39-51 of the UNCITRAL Insolvency Guide).

108. An important question is whether a reclamation right relating to specific tangible assets should have priority over a pre-existing security right in the same assets, either outside or inside the insolvency context. In other words, the question is whether, if the assets of the buyer (including the assets sought to be reclaimed) are subject to a security right, the reclaimed assets should be returned to the seller free of such security right. In some States, the reclamation has a retroactive effect, placing the seller in the same position as it was prior to the sale (holding assets that were not subject to any security rights in favour of the buyer’s creditors). That is, the reclamation right is seen as a right that follows from general principles of the law of sale meant especially to protect small-scale sellers when the buyer fails to perform its correlative obligations. However, in other States, the assets remain subject to the pre-existing security rights, provided that the security rights became effective against third parties before the supplier exercises its reclamation right. The rationale for this approach is that the holders of such security rights would probably have relied on the existence of the assets being reclaimed when extending credit. In addition, if the reclamation rights were given priority in this situation, the response of inventory acquisition financiers often will be to reduce the amount of credit extended to the grantor by “reserving” for potential reclamation claims.

109. Where States have enacted a modern secured transactions regime of the type envisioned in the *Guide*, the seller is able to protect itself by obtaining an acquisition security right in the assets and therefore much of the policy sought to be promoted by providing for reclamation rights can usually be achieved by other means. The *Guide*, consequently, recommends that reclamation rights should not have priority over a competing security right unless they are exercised before the security right became effective against third parties (see recommendation 86).

(h) Priority of a security right in an attachment

110. Tangible assets often may become attachments to other tangible assets (whether movable, as in the case of tyres attached to road vehicles, or immovable, as in the case of chandeliers or furnaces attached to buildings). In these cases, there often can be conflicts between security rights created in the attachment and security rights created in the object to which the attachment is affixed. Different policy considerations come into play in determining the relative priority of these security rights when attachments to immovable property or attachments to movable assets are involved.

(i) Priority of a security right in an attachment to immovable property

111. To the extent that a secured transactions regime permits security rights to be created in attachments to immovable property (as recommended in the *Guide*; see recommendation 21), it must also include rules governing the relative priority of a holder of a security

right in an attachment to immovable property vis-à-vis persons that hold rights with respect to the related immovable property. A paramount consideration of such priority rules is to avoid unnecessarily disturbing well established principles of immovable property law.

112. Such priority rules will have to address a number of different priority conflicts. The first is a conflict between a security right in an attachment (or any other right in an attachment, such as the right of a buyer or a lessee) that is created and made effective against third parties under immovable property law and a security right in the attachment that is made effective against third parties under the secured transactions regime governing movable assets. In this situation, out of deference to immovable property law, most States give priority to the right created and made effective against third parties under immovable property law. With a view to preserving the reliability of the immovable property registry, this is also the position taken in the *Guide* (see recommendation 87).

113. A second type of priority conflict may arise when a security right in an encumbered asset that is either an attachment to immovable property at the time the security right becomes effective against third parties or that becomes an attachment to immovable property subsequently is made effective against third parties by registration in the immovable property registry. The issue is to determine priority as between the security right in the attachment and a security right (or other right, such as the right of a buyer or lessor) in the related immovable property. In these cases, most States take the position that priority will be determined according to the order of registration of the rights in the immovable property registry. Once again, the rationale is to preserve the reliability of the immovable property registry, a rationale that also underlies the position taken in the *Guide* (see recommendation 88).

114. A third type of priority conflict may arise between an acquisition security right in an encumbered asset that becomes an attachment to immovable property and an encumbrance on the immovable property. In order to promote the financing of the acquisition of attachments, many States provide that the acquisition security right has priority, on the condition that it be registered in the immovable property registry within a short period of time (such as 20-30 days) after the encumbered asset becomes an attachment. For the same reason, the *Guide* recommends that priority be given to the acquisition security right in the encumbered asset that later becomes an attachment (see recommendation 184; under recommendation 195, the same principle will also apply in cases where the acquisition financier in the non-unitary regime has a retention-of-title right or a financial lease right).

(ii) *Priority of a security right in an attachment to a movable asset*

115. Several types of priority conflict may arise with respect to security rights in assets that later became attachments to movable assets. One type of priority conflict may arise between two or more security rights in an asset that later became an attachment to another movable asset. Another priority conflict may arise between a security right in an asset that later became an attachment to a movable asset and a security right in the relevant movable asset to which the attachment was attached, where both have been registered in the general security rights registry. In each of these cases, priority may be determined in accordance with the general priority principle, since the fact of

attachment is not material to determining priority. The *Guide* recommends this approach. Priority in these situations should be determined by the order of registration or third-party effectiveness (see recommendation 76), except in the case where the security right in the attachment is an acquisition security right (see chapter IX on acquisition financing).

116. Special priority rules are, however, needed to deal with three situations that arise in cases where the security right has been made effective against third parties by virtue of its registration in a specialized registry or its notation on a title certificate. An initial type of priority conflict in such cases may arise between a security right in an asset that later became an attachment where that security right was made effective against third parties by registration in a specialized registry or notation on a title certificate and a security right in the related movable asset that was registered in the general security rights registry. In this situation, States usually give priority to the former right in deference to the policy in favour of preserving the integrity of specialized registries and title-notation systems. The *Guide* recommends this approach (see recommendation 77, subparagraph (a)). A second type of priority conflict may arise between two security rights in assets that later became attachments to one or more movable assets, where both rights have been made effective against third parties by registration in a specialized registry or notation on a title certificate. A third priority conflict may arise between a security right in an asset that later became an attachment and a security right in the relevant movable asset to which the attachment was attached, where both rights have been made effective against third parties by registration in a specialized registry or notation on a title certificate. In these latter two cases, most States provide that priority is determined according to the time of such registration or notation. Once again, to preserve the integrity of these registries, this is the approach recommended in the *Guide* (see recommendations 77, subparagraph (b), and 89).

(i) *Priority of a security right in a mass or product derived from a security right in processed or commingled assets*

117. Many types of tangible asset are destined to be manufactured, transformed or commingled with other tangible assets of the same kind. This circumstance gives rise to three types of potential priority contest that require special rules. These three types are: (a) contests between security rights taken in the same items of tangible assets that ultimately become commingled in a mass or product (for example, sugar and sugar; oil and oil; grain and grain); (b) contests involving security rights in different tangible assets that ultimately become part of a mass or product (for example, sugar and flour, fibreglass and polyester resin, cloth and dye in fabrics); and (c) contests involving a security right originally taken in separate tangible assets and a security right taken in the mass or resulting product (for example, sugar and cake, fibreglass and furniture, cloth and trousers). Each of these potential contests is discussed below. It is important to note, however, that in many cases the security right will not only encumber the raw materials that are ultimately commingled into a product or a fraction of the fungible asset that is commingled into a mass. It will also encumber, as a future asset (see recommendation 17), the manufactured product and the entire mass as an original encumbered asset. In these cases, the priority of the security right in the fraction of the mass or product will also carry over into the entire mass or product and the basic priority rule will apply (recommendation 76).

(i) *Priority of security rights in the same tangible assets that are commingled in a mass or product*

118. States typically provide that non-possessory security rights in the same tangible assets that become commingled continue into the mass or product and have the same priority as against each other as they had prior to the commingling. The rationale for this rule is that the commingling of tangible assets into a mass or product should have no bearing on the respective rights of creditors with competing security rights in the separate tangible assets. As between each other, they should be in an identical position. For example, if secured creditor A has a first-ranking security right in €100,000 worth of oil and secured creditor B has a second-ranking security right in that oil, when that oil is commingled with other oil, the priority of secured creditors A and B should remain the same. A like result would occur in the case of competing security rights in flour that is combined with other ingredients to bake cakes. The *Guide* recommends this principle as well (see recommendation 90). Of course, in these cases, in order to maintain equity between the secured creditors as a group and other secured creditors that may have security rights in other assets contributing to the mass or product, the total amount available to satisfy the claims of the secured creditors cannot exceed the value of the tangible assets encumbered by their competing security rights immediately before they became commingled in the mass or product (see recommendation 22).

(ii) *Priority of security rights in different tangible assets that become part of a mass*

119. The second type of priority competition arises between security rights in different tangible assets that ultimately become part of a mass. States have taken different approaches to deciding this question, depending on how they determine the extent of the secured creditor's rights in the mass. As noted, most legal systems provide that the security right may be claimed in the commingled assets in the same proportion as the encumbered asset bears to the total amount of the commingled assets. Under this approach, if €100,000 worth of encumbered oil is commingled with €50,000 worth of oil in the same tank, the secured creditor is deemed to have a security right in two thirds of whatever oil remains in the tank at the time it becomes necessary to enforce the security right. As the *Guide* adopts the general principle that security rights should be protected as much as possible, it recommends this approach. The pre-commingling priority of the security right should be preserved in the commingled assets in the same proportion as the encumbered assets and the assets not encumbered by the security right contributed to the mass (see recommendation 91).

(iii) *Priority of security rights in different tangible assets that become part of a product*

120. If security rights in different tangible assets that ultimately become part of a product continue in the product, the issue is how to determine the relative value of the rights that may be claimed by each creditor. States have taken many approaches to deciding this question, depending on how they decide the extent of the secured creditor's rights in the product. The *Guide* recommends that secured creditors should be entitled to share in the aggregate maximum value of their security rights in the product according to the ratio of the value of the assets encumbered by their respective security rights immediately prior to

manufacture or incorporation to the value of all the components at that time (see recommendation 22). Using the example of the cake, if, at the time of the commingling, the value of the sugar is 2 and the flour 5, while the value of the cake when baked is 8, the creditors will receive 2 and 5, respectively, but neither secured creditor will receive more than the amount of its secured obligation. Conversely, if, at the time of the commingling, the value of the sugar is 2 and the flour 5, while the value of the cake when baked is 6, the creditors will receive two sevenths and five sevenths of 6, respectively. Each creditor in this situation will suffer a proportional decrease.

121. It follows that in these types of case, each creditor is entitled to claim its pre-manufacture priority in the share of the final product that represents the value of the component part over which it had taken security. This means that, if the secured claim of one secured creditor is less than the value of its component part and the secured claim of another secured creditor is greater than the value of its component part, the second secured creditor cannot claim a priority right in the excess value attributable to the share of the first secured creditor. As noted in paragraph 117 above, to avoid these limitations many secured creditors draft security agreements that describe the encumbered assets as including not only the component parts, but also any mass or product that is manufactured from the component parts. However, in cases where the security agreement does not cover future assets, States typically follow the relative valuation formula described above for determining the rights of secured creditors with security rights in different components of a mass or product. This is also the approach recommended in the *Guide* (see recommendation 91).

(iv) *Priority of a security right originally taken in tangible assets as against a security right in a mass or product*

122. Another type of competition that States must resolve is that between security rights in tangible assets that become part of a mass or product and security rights taken in the mass or product itself. Generally, States take the position that the regular priority rules apply to govern these conflicts. For example, if secured creditor A has a security right in sugar that is the subject of a notice registered on 1 January and secured creditor B has a security right in present and future cakes that is the subject of a notice registered on 1 February, secured creditor A will have priority, subject to the limitation, set out in recommendation 22, that its security right is limited to the value of the assets immediately before they became part of the mass or product. Conversely, if secured creditor A has a security right in sugar that is the subject of a notice registered on 1 February and secured creditor B has a security right in present and future cakes that is the subject of a notice registered on 1 January, secured creditor B will have priority.

123. There is, however, one exception to this principle, which arises where the secured creditor that takes security in a component part is an acquisition financier (see chapter IX on acquisition financing). In these cases, in keeping with the general treatment of acquisition financiers, States usually give the acquisition security right priority over all security rights in the mass or product that extend to future assets. To maintain a consistent regime promoting the availability of credit for the acquisition of tangible assets, the *Guide* also recommends adoption of this principle (see recommendation 92).

(v) *Impact of inflation on the application of these principles*

124. In the various situations discussed in this subsection, the value of the security right in an asset that becomes commingled into a mass or product is limited in three ways. First, under general principles of secured transactions law, it cannot be claimed for an amount greater than what is owed under the secured credit agreement. Secondly, it cannot be claimed for a greater proportion of the total value of the commingled product or mass than the proportion that the encumbered asset contributed to value of the product or mass. Thirdly, it cannot be claimed for an amount greater than the value of the encumbered asset at the time it was incorporated into the mass or product. There is, however, one possible exception to this rule in cases of inflation. For example, a security right in oil may partially secure an obligation of €100,000 and the value of the oil immediately before commingling may be €80,000, while the percentage of the encumbered asset in the commingled whole may be 33 per cent. If the commingled oil is sold progressively so that only 50 per cent of the total amount remains, under the principles just discussed the maximum value of the security right would be 50 per cent of €80,000 (that is, €40,000). However, if in the interval the price of oil has tripled, the secured creditor should be entitled to claim whatever inflated value the oil might possess, as long as it does not exceed the 33 per cent share of the value of the whole of the commingled oil. Thus, in this case, the maximum value of the security right would be the lower of €100,000 or €120,000 (€40,000 times 3).

6. *Scope and interpretation of priority rules*

(a) *Irrelevance of knowledge of the existence of a security right*

125. One of the key features of a modern secured transactions regime is that, regardless of the basis adopted for determining priority, priority will be determined by reference to objective facts (such as registration of a notice, possession, a control agreement and a notation on a title certificate). For such a priority system to provide certainty, these objective facts must be the exclusive means for determining priority. This is why, in most States that have modernized their regime of security rights, the ordering of priority as established by, for example, the date of registration of a notice or creditor possession applies even if a subsequent creditor or other competing claimant acquired its rights with knowledge of an existing security right that was not then registered or otherwise effective against third parties.

126. The rationale for this rule is based on the premise that it is often difficult to prove that a person had knowledge of a particular fact at a particular time. This is especially true in the case of a corporation or other legal entity with numerous employees. Priority rules that are dependent on subjective knowledge provide opportunities to complicate dispute resolution, thereby diminishing certainty as to the priority status of secured creditors and reducing the efficiency and effectiveness of the system. While it might seem inappropriate to give priority to a creditor that knows of a security right already created by a grantor, basing priority on the order of a publicly verifiable event through which a creditor makes its rights effective against third parties ensures certainty in the relationships between potentially competing claimants. This consideration supports the recommendation in the *Guide* that mere knowledge of a security right is irrelevant to the determination of priority (see recommendation 93).

127. This said, it is important to distinguish knowledge merely of the existence of a security right from knowledge that a particular transaction violates the rights of a secured creditor. For example, knowledge by a buyer of a registered or unregistered security right will not disrupt the priority regime established for security rights with respect to which a notice has been registered on the basis of the objective fact of registration of a notice. By contrast, should the buyer know as well that the asset it acquires is being sold in contravention of the specific terms of a security agreement (for example, a prohibition on the grantor's right to sell encumbered assets), significant legal ramifications may well follow (see para. 68 above on acquiring title to the asset subject to existing security rights; see also recommendations 81, 102, subparagraph (b), 105 and 106). Moreover, other consequences may follow based on law other than secured transactions law if the sale constitutes fraud.

(b) *Freedom of contract with respect to priority: subordination*

128. The priority regime in most States establishes rules that apply unless they are specifically modified by affected parties. In other words, most States provide that a secured creditor may at any time, whether unilaterally or by agreement, subordinate its security right to the right of an existing or future competing claimant. For example, lender A, holding a first-priority security right in all existing and after acquired assets of a grantor, may agree to permit the grantor to give a first priority security right in a particular asset (such as a piece of equipment) to lender B so that the grantor can obtain additional financing from lender B based on the value of that asset. The recognition of the validity of subordination of security rights reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention). Consistent with the widespread recognition of the utility of subordination agreements, the *Guide* recommends that they be permitted (see recommendation 94).

129. However, subordination cannot affect the rights of a competing claimant without its consent. Thus, a subordination agreement cannot adversely affect the priority of a secured creditor that is not a party to that agreement. This means that, in those States which require creditors to indicate in the registered notice the maximum amount for which a security right is granted (see recommendation 57, subparagraph (d)), the subordination will be limited to the indicated value of the higher-ranking right. Thus, for example, if lender A has limited its security right to €100,000, lender B has security for €50,000 and lender C has security for €200,000, a subordination agreement by lender A in favour of lender C cannot operate so as to permit lender C to claim more than €100,000 by priority over lender B.

130. The purpose of a subordination agreement is to permit secured creditors to agree among themselves as to the most efficient allocation of priority of their rights in encumbered assets. To obtain the full benefit of these consensual allocations, it is essential that the priority afforded by a subordination agreement continue to apply in insolvency proceedings of a grantor. In some jurisdictions, such a provision already exists in the insolvency regime. In other jurisdictions, it may be necessary to amend insolvency laws so as to empower the courts to enforce a subordination agreement and to enable insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see chapter XII on the impact of insolvency on a security right, para. 63, and recommendation 240).

131. Subordination of security rights and other property rights in encumbered assets does not mean subordination of payments prior to default. This is a matter for the general law of obligations. Normally, prior to default and as long as the grantor continues to repay the loan or other credit received, a secured creditor is not entitled to enforce its security right and priority is not an issue. As a result, as long as no fraud is being committed and in the absence of an agreement to the contrary between a grantor and a secured creditor, a grantor is not precluded from making payments on obligations secured by subordinate security rights.

(c) *Impact of continuity of third-party effectiveness on priority*

132. Where the third-party effectiveness of a security right may be achieved by more than one method (for example, automatically, by registration, by possession, by control or by notation on a title certificate), a question arises as to whether a secured creditor that initially established the priority of its security right by reference to one of these methods should be permitted to change to another method without losing its original priority. Some States do not permit creditors to change the means by which they have achieved third-party effectiveness. As a result, in these States it is not possible for a creditor's priority to be maintained following such a change. For example, if a creditor registers a notice in the general security rights registry on day 1, on day 10 obtains possession of the encumbered asset and on day 20 cancels the registration, from that time onwards the relevant time for establishing priority in these States would be day 10, not day 1.

133. In other States, it is possible to maintain priority even after a change in the method by which third-party effectiveness is achieved. Whether priority is maintained depends on the manner in which the different methods for achieving third-party effectiveness are integrated. In States that permit a change in the method of achieving third-party effectiveness, the principle is that a security right will not lose its priority as long as there is no time during which the security right is not effective against third parties. For example, if a security right in an asset first becomes effective by possession and the secured creditor subsequently registers a notice of the security right in the general security rights registry and returns possession to the grantor, the security right remains effective as against third parties and priority relates back to the time that possession was initially obtained (as long as the registration precedes the creditor's surrender of possession). If, however, the secured creditor registers the notice after it surrenders possession of the asset, the priority of the security right dates only from the time that the secured creditor registers the notice. Rules providing for continuity in priority are especially important in cases where effectiveness against third parties was first established through possession because the grantor did not require the use of the encumbered asset but, in cases where, at some later point during the credit arrangement, the grantor needs to use the asset in its business and the asset is returned to it. Consistent with its recommendations relating to continuity of third-party effectiveness (see recommendations 46 and 47), the *Guide* recommends that, for the purpose of applying the temporal priority rules recommended in the *Guide*, priority should be maintained notwithstanding a change in the method by which it is determined (see recommendations 95 and 96).

134. It should be noted that the above-mentioned rule applies only to situations where temporal priority rules are applied to determine priority and does not apply to situations

where non-temporal rules are applied. In the latter case, a change in the mode of third-party effectiveness will affect the priority of a security right, even if third-party effectiveness is continuous. For example, if the holder of a negotiable instrument registers a notice of a security right in the instrument prior to surrendering possession, the special priority attaching to possession of the instrument will not be maintained simply through the registration. Should a second secured creditor register a notice before the secured creditor surrendering possession registered its notice, the second secured creditor will take priority based on its prior registration (see recommendation 101). Similarly, if a secured creditor having control with respect to a right to payment of funds credited to a bank account registers a notice of its security right and then surrenders control, the special priority attaching to control is lost. Should another secured creditor have registered a notice in the general security rights registry before the initial taking of control, once control is surrendered that other secured creditor would have priority based on its prior registration (see recommendation 103).

(d) Extent of priority: conditional and future obligations

135. Previous chapters have addressed the fact that, in modern secured transactions regimes, a security right can secure not only obligations existing at the time the security right is created, but also future and conditional obligations as well (see chapter I on the scope of the *Guide*, para. 12, and chapter II on the creation of a security right, paras. 41-42; see also recommendation 16). Most States provide that the initial security right covers principal and interest as stipulated in the agreement as well as any fees and costs associated with recovery of payment.

136. As for situations where lenders provide additional funds in the future under existing credit arrangements (sometimes referred to as “future advances”) and situations involving future and conditional obligations, States take different positions. Some States give the same priority to a security right securing the payment of future and conditional obligations as the security right had with respect to the original secured obligation, provided that the future and conditional obligations are determinable both as to type and amount. For example, the agreement may specify that only future obligations under a line of credit up to a maximum exposure of €100,000 is secured. In other States, a security right may extend to all monetary and non-monetary obligations owed to the secured creditor of whatever type and in whatever amount, as long as the agreement so specifies. In these States, security rights securing the payment of future and conditional obligations under the security agreement will have the same priority as the security right have with respect to the original secured obligation.

137. The practical consequence of the latter approach is that a secured creditor is assured, at the time it makes a commitment to extend credit, that the priority of its security right will extend not only to the credit it extends contemporaneously with the conclusion of the security agreement, but also to: (a) obligations that arise thereafter pursuant to the terms of the security agreement (such as future advances under a revolving credit agreement); and (b) conditional obligations that become actual obligations when a condition is met (such as obligations that become payable to the secured party under a guarantee). For example, in the case of a revolving credit facility under which the lender has agreed on day 1 to make advances to the grantor from time to time for the entire one-year term of

the facility secured by a security right in the grantor's assets, the security right will have the same priority for all of the advances made, regardless of whether they are made on day 1, day 35 or day 265.

138. In the case of credit extended to enable a grantor to purchase tangible assets or services in instalments over time, this approach results in the entire claim being treated as coming into existence at the time when the contract for the purchase of the tangible assets or services is entered into, not at the time of each delivery of tangible assets or rendering of services. One rationale for this approach is that it is the most cost-efficient approach because it relieves the secured creditor of the need to determine priority each time it extends credit, a determination that typically involves additional searches for new registrations by other creditors, the execution of additional agreements and additional registrations for amounts of credit extended subsequent to the time the security right was created. Because the costs associated with these additional steps invariably are passed on to the grantor directly or reflected in an increase in the interest rate, eliminating them can reduce the cost of credit for the grantor. Another rationale for this approach is that it minimizes the risk to the grantor that a security right securing payment of the amount of credit subsequently extended under the security agreement will be interrupted if the secured creditor determines that such a security right does not have the same priority as it had with respect to the initial disbursement of credit. For these reasons, the *Guide* recommends that the initial priority of a security right securing a present obligation be maintained for any future obligations that the security right may secure (see recommendation 97).

139. The foregoing priority rules are, nonetheless, subject to two potential limitations. First, as noted, in some States where the priority of a security right extends to future obligations, priority is limited to the maximum amount specified in the notice registered in a public registry with respect to the security right. The rationale for this approach is that it may encourage subordinate financing by encouraging prospective subordinate creditors to extend credit on the residual value of the encumbered assets (for example, the value of the encumbered assets in excess of the maximum amount secured by the higher-ranking security right referred to in the registered notice) to the extent the prospective creditor is able to satisfy itself that a sufficient residual value exists (see recommendation 98). Other States do not take this approach, on the basis that it might encourage secured creditors to inflate the amount mentioned in the registered notice to include an amount greater than that contemplated at the time of the security agreement to accommodate possible unanticipated future extensions of credit (see chapter IV on the registry system, paras. 92-97; see also recommendation 57, subparagraph (d)).

140. Second, the *Guide* recognizes that, in some circumstances, a secured creditor should not be able to assert the priority of its security right with respect to future obligations against a creditor that obtains a judgement or provisional court order against the grantor and takes steps to enforce the judgement against the encumbered assets (see recommendations 84 and 97).

(e) *Application of priority rules to a security right in future assets*

141. As discussed in greater detail in chapter II on the creation of a security right (see chapter II on the creation of a security right, paras. 51-55), in some States a security

right may be created in assets that the grantor may acquire in the future (such as inventory) or that may arise in the future (such as receivables or products to be manufactured in the future). The first category of assets is sometimes referred to as “after-acquired assets”, while the second category of assets is sometimes referred to as “future assets”. In the *Guide*, the term “future assets” is used to refer to both categories of asset. In States that permit the creation of security rights in future assets, assuming that the description of the future assets is sufficient to identify them, a security right in these assets is obtained automatically at that time, without any additional steps being required at the time the assets arise or are acquired by the grantor. As a result, the costs incidental to the creation of the security right are minimized and the expectations of the parties are met. This is especially important with respect to inventory that is continuously being acquired for resale, receivables that are continuously being collected and generated, and equipment that is periodically being replaced in the normal operation of the grantor’s business.

142. The recognition of the automatic creation of a security right in future assets raises the question as to whether priority should date from the time when the security right is first registered or becomes effective against third parties or from the time the assets arise or the grantor acquires them. Different States address this matter in different ways. Some States adopt an approach that differentiates according to the nature of the creditor competing for priority. In these States, priority dates, as against other consensual secured creditors, from the date of registration or third party effectiveness and, as against all other competing claimants, from the date the asset arises or is acquired by the grantor. In other States, priority for all future assets, and as against all competing claimants, is determined by reference to the date priority was initially established.

143. It is generally accepted that the second of these approaches is more efficient and effective in promoting the availability of secured credit. Thus, modern secured transactions regimes typically specify that, in such cases, the priority of a security right extends to all encumbered assets covered by the registered notice, regardless of whether they come into existence or are acquired by the grantor before, at or after the time of registration. This is the approach taken in the *Guide* (see recommendation 99).

(f) Application of priority rules to a security right in proceeds

144. If a creditor has a security right in proceeds, issues will arise as to the priority of that security right as against the rights of competing claimants. Competing claimants with respect to proceeds will typically include creditors with security rights in the proceeds as proceeds of other assets and creditors with security rights in the proceeds as original encumbered assets (assets that constitute proceeds to one secured creditor may constitute original encumbered assets to another secured creditor).

145. For example, creditor A may have a security right in all of the grantor’s receivables by virtue of its security right in all of the grantor’s existing and future inventory and the proceeds arising upon the sale or other disposition thereof; creditor B may have a security right in all of the grantor’s existing and future receivables as original encumbered assets. If the grantor later sells on credit inventory that is subject to the security right of creditor A, both creditors have a security right in the receivables generated by the sale: creditor A

has a security right in the receivables as proceeds of the encumbered inventory and creditor B has a security right in the receivables as original encumbered assets.

146. The approach to priority taken in States that recognize a security right in proceeds will often differ depending on the nature of the competing claimants and the type of asset that gives rise to the proceeds. In priority disputes between holders of competing security rights, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to rights in the original encumbered assets. Thus, the time of third-party effectiveness or the time of registration of a notice in the general security rights registry of a security right in an encumbered asset would also be the time of third-party effectiveness or registration, respectively, of a security right in the proceeds of such encumbered asset.

147. In the case of competitions between security rights in assets as proceeds and security rights in these assets as original encumbered assets, some States distinguish between proceeds in the form of receivables and proceeds in the form of tangible assets. These States also typically distinguish between proceeds arising from the sale of inventory and proceeds arising from the sale of equipment. The general rule is that a security right in receivables generated by the sale of inventory as original encumbered assets will have priority over a security right in those receivables as proceeds of inventory, regardless of the respective dates on which the security rights became effective as against third parties.

148. In other States, no distinctions as to the form of proceeds or the nature of the assets are made. The rule is that the first right in specific assets that is reflected in a registration has priority over the rights of a competing claimant. For example, if the registration of the security right in assets the sale of which generates the proceeds predates the registration of the security right in the proceeds as original encumbered assets, the security right in the assets generating the proceeds has priority even with respect to the proceeds. Conversely, if a notice was registered with respect to the right in the proceeds as original encumbered assets before the competing claimant made a registration with respect to the assets giving rise to the proceeds, the security right in the proceeds as original encumbered assets would have priority. This is the approach recommended in the *Guide* (see recommendation 100).

149. In cases in which the order of priority of competing rights in the original encumbered assets is not determined by the order of registration in the general security rights registry (as is the case, for example, with acquisition security rights that enjoy a special priority position), a separate determination will be necessary for the priority rule that would apply to proceeds (see chapter IX on acquisition financing, paras. 158-172; see also recommendations 185, 198 and 199). A separate determination will also be necessary where the priority rules for certain types of asset or for certain methods of achieving third-party effectiveness depart from the temporal approach. For example, the *Guide* provides that a security right in an asset subject to a specialized registry that is registered in that registry will have priority over a security right that has been registered earlier in the general security rights registry (see recommendation 77). However, this special priority relates only to original encumbered assets and not to any proceeds unless the proceeds were themselves subject to registration in the specialized registry. This could happen, for example, if part of the proceeds of disposition of an automobile consisted of another automobile received in exchange. Conversely, if the proceeds were in the form of receivables, the

normal priority rules relating to receivables (that is, the first to register in the general security rights registry) would be applicable.

150. In each of the situations to be reviewed in section B below it is important to note that the special priority relates only to the specific asset (that is, a negotiable instrument, a right to payment of funds credited to a bank account or a right to receive the proceeds of an independent undertaking). In all these cases, if the proceeds arise in the same form as the original encumbered assets, the special priority rules continue to apply; but if the proceeds take a different form, the priority of competing rights will be determined by the rules applicable to the type of asset that constitutes the proceeds.

B. Asset-specific remarks

151. The various specific priority conflicts that generally recur in connection with tangible assets have been reviewed above. The first-in-time principle is an efficient starting point for establishing priority.

152. As noted, however, the principle requires adjustment in certain cases. Some adjustments involve other secured creditors (for example, holders of security rights in attachments and security rights in masses or products). Other adjustments involve competing claimants that are not secured creditors (for example, transferees, lessees, licensees and insolvency representatives).

153. In addition to these adjustments resulting from the diversity of obligations being secured and the diversity of competing claimants, modern secured transactions regimes also contain a number of special priority rules that apply to particular types of asset and flow from the particular means for achieving third-party effectiveness applicable to these types of asset. This section deals with priority issues relating to such types of asset.

1. Priority of a security right in a negotiable instrument

154. Many States have adopted special priority rules for security rights in negotiable instruments, such as cheques, bills of exchange and promissory notes. These rules are a reflection of the importance of the concept of negotiability in those States.

155. As already discussed (see chapter III on the effectiveness of a security right against third parties, paras. 47-51), in many States security rights in negotiable instruments may be made effective either by registration of the security right in the general security rights registry or by transfer of possession of the instrument (see recommendation 37). In these States, priority is often accorded to a security right made effective against third parties by transfer of possession of the instrument over a security right made effective against third parties by registration, regardless of when registration occurs. The rationale for this rule is that it resolves the priority conflict in favour of preserving the unfettered negotiability of negotiable instruments. To preserve the coherence of existing law governing negotiable instruments, the *Guide* recommends this priority principle (see recommendation 101).

156. For the same reason, in these States priority is often accorded to a buyer or other transferee (in a consensual transaction), if that person qualifies as a protected holder of the

instrument under the law governing negotiable instruments. A similar priority is also given if the buyer or other transferee takes possession of the instrument and gives value in good faith and without knowledge that the transfer is in violation of the secured creditor's rights. It should be noted in this regard that knowledge of the existence of a security right on the part of a transferee of an instrument does not mean, by itself, that the transferee did not act in good faith. The buyer must know that the transfer free of the security right is prohibited under the security agreement. Here also, the *Guide* adopts a priority rule that follows the above-mentioned principles of negotiable instruments law (see recommendation 102).

2. Priority of a security right in a right to payment of funds credited to a bank account

157. A comprehensive priority regime typically addresses a number of different priority conflicts relating to security rights in rights to payment of funds credited to a bank account. Some States consider the right to payment of funds credited to a bank account simply to be a receivable. In these States, no special rules govern the creation or the third-party effectiveness of security rights in the right to payment. In other States, third-party effectiveness may also be achieved by control. In these cases, States must also determine the priority consequences of achieving third-party effectiveness by such a method. Several different priority conflicts are possible.

158. One type of priority conflict is between a security right made effective against third parties by control and a security right made effective against third parties by a method other than control. In this situation, States that have adopted the concept of control accord priority to the security right made effective against third parties by control. The reason is that this outcome facilitates financial transactions that rely on rights to payment of funds credited to a bank account, relieving secured creditors from the necessity of searching the general security rights registry. This is also the position taken in the *Guide* (see recommendation 103, first sentence).

159. A second type of priority conflict is that between two security rights, each of which is made effective by control. Here, the logical outcome, usually adopted in States that recognize control agreements, is to accord priority to the security right that was first made effective by control (that is, in the order in which the respective control agreements were concluded). This conflict will not arise often in practice, because it is unlikely that a depositary bank will knowingly enter into more than one control agreement with respect to the same bank account in the absence of an agreement between both secured creditors as to how priority will be determined. Nonetheless, the conflict is theoretically possible and the *Guide* therefore takes the position that the normal "first-in-time" priority principle should apply in these cases (see recommendation 103, second sentence).

160. A third type of priority conflict is where one of the secured creditors is the depositary bank itself. In this situation, a strong argument exists in favour of according priority to the depositary bank. As the depositary bank generally will win in such a situation by reason of the right of set-off that it generally enjoys under law other than secured transactions law (unless it has expressly waived its right), a priority rule that favours the bank in this circumstance allows the conflict to be resolved within the confines of the priority regime without resorting to other law. This principle is recommended in the *Guide* (see recommendation 103, third sentence).

161. States that adopt the special priority rule just noted often make an exception for the circumstance in which the priority conflict is between the depositary bank and a secured creditor that obtains control of the bank account by becoming the customer of the depositary bank. In such cases, these States generally take the position that priority should be given to the customer. The rationale for this approach is that, by accepting the competing secured creditor as its customer, the depositary bank should be deemed to have released its claim in the deposit agreement that it enters into with its customer. Also, the depositary bank would often lose its right of set-off in this situation; since the bank account is not in the grantor's name, there would be no mutuality between the depositary bank and the grantor and, hence, no right of set-off (see recommendation 103, third sentence).

162. A fourth type of conflict is one between a security right in a right to payment of funds credited to a bank account and any rights of set-off the depositary bank might have against the grantor-client. To avoid undermining the bank-client relationship, the law of set-off generally gives priority to the depositary bank's rights of set-off. In some States, this concept of priority has been explicitly incorporated into the secured transactions law. This is also the position that is recommended in the *Guide* (see recommendation 104).

163. A fifth type of priority conflict can arise between a security right in a right to payment of funds credited to a bank account and the rights of a transferee of funds from that bank account where the transfer is initiated by the grantor. The term "transfer of funds" is intended to cover a variety of transfers, including by cheque and electronic means. In these situations, a strong policy argument in favour of the free negotiability of funds supports a rule that accords priority to the transferee, so long as the transferee was not aware that the transfer of funds to it was in violation of the rights of a secured creditor under its security agreement. If, on the other hand, the transferee knew that the transfer violated the security agreement, it would take the funds subject to the security right. This is the recommendation of the *Guide*, subject to the caveat that the recommendation is not intended to affect adversely the rights of transferees of funds from bank accounts under law other than the secured transactions law (see recommendation 105).

3. Priority of a security right in money

164. In the interest of maximizing the negotiability of money, many States permit a transferee of money to take the money free of the claims of other persons, including the holders of security rights in the money. As in the case of transferees of funds from a bank account, the only exception to this priority rule is if the transferee had knowledge that the transfer of the money is in violation of the security agreement between the account holder and the secured party (for example, if the transferee has colluded with the holder of the bank account to deprive the secured creditor of its rights). As in similar situations involving the transfer of funds from bank accounts, mere knowledge of the existence of the security right would not defeat the rights of the transferee. Here also, in keeping with generally accepted practice governing money, the *Guide* recommends this priority principle (see recommendation 106).

4. *Priority of a security right in a right to receive the proceeds under an independent undertaking*

165. The law governing independent undertakings has developed largely through practices in the letter-of-credit and bank-guarantee industry. As already mentioned (see chapter III on the effectiveness of a security right against third parties, paras. 149-153), a security right in a right to receive the proceeds under an independent undertaking is made effective against third parties only by control. As the typical method of achieving control in this context is by obtaining an acknowledgment, in the case of several potential payers (such as a guarantor/issuer, confirmer and several nominated persons), control may be achieved only as against each particular guarantor/issuer, confirmer or nominated person that gave an acknowledgment. Thus, the priority rule normally focuses on the person that is the payer.

166. Normally, in the rare case of a priority contest between the holder of a security right in a right to receive the proceeds under an independent undertaking that has been made effective by control and a security right made effective against third parties by reason of the fact that it secures payment of a receivable, negotiable instrument or other intangible asset, the former will prevail (see recommendations 48 and 107). As in the case of bank accounts, this rule is based on the need to facilitate transactions involving independent undertakings by relieving parties of the necessity of searching the general security rights registry to determine whether the receivable supported by the independent undertaking is also subject to a security right, thereby encouraging reliance on independent undertakings. As a practical matter, this type of priority conflict is quite rare, because in most cases the beneficiary of the receivable will also be the beneficiary of the independent undertaking. In any case, consistent with the general first-in-time principle, as between two security rights made effective against third parties by control through acknowledgment, priority is accorded to the first security right to be acknowledged by the payer. The rationale for this result is largely practice-based, in that it is a special rule required in order to keep low the cost of independent undertakings. As independent undertakings constitute a highly specialized branch of commercial law that has been largely developed by practice, the *Guide* recommends that relevant priority rules be consistent with these principles (see recommendation 107).

5. *Priority of a security right in a negotiable document or tangible assets covered by a negotiable document*

167. Modern secured transactions regimes typically have rules that address at least two priority conflicts involving negotiable documents (such as negotiable warehouse receipts and bills of lading). The first is a conflict between the holder of a security right in a negotiable document or the tangible assets covered thereby, on the one hand, and a person to whom the document has been duly negotiated, on the other hand. In the interest of preserving negotiability under non-secured transactions law, most States provide that the security right in the negotiable document and the tangible assets covered thereby will be subordinate to any superior rights acquired by the transferee of the document under the law governing negotiable documents. For the same reason, this is the approach recommended in the *Guide* (see recommendation 108).

168. The second type of conflict is between the holder of a security right in the tangible assets covered by the negotiable document that is derived from a security right in the negotiable document and the holder of a security right in the tangible assets resulting from some other transaction (for example, the creation of a direct security right in the tangible assets). This type of conflict can arise either where the direct security right in the tangible assets became effective against third parties while the tangible assets were subject to the negotiable document or where the direct security right in the tangible assets became effective against third parties before the tangible assets became subject to the negotiable document. In either situation, priority is usually given to the security right in the negotiable document. Such a priority rule encourages reliance on negotiable documents as a medium of commerce, especially in connection with bills of lading issued in connection with international sales. It is, therefore, the approach recommended in the *Guide* (see recommendation 109).

169. However, an exception to this rule is warranted in the specific situation where the tangible asset subject to the negotiable document is an asset other than inventory. Creditors normally expect that inventory will be shipped and a bill of lading or warehouse receipt will be issued and therefore can anticipate a short period where assets that their security right directly encumbers will be covered by a bill or receipt. This is not usually the case with, for example, equipment. Hence, the rule giving absolute priority to a security right in negotiable documents has less significance for assets other than inventory and an exception may be justified. Thus, the rule is inapplicable where the tangible assets are assets other than inventory and the direct security right (that is, the security right of the secured creditor not in possession of the negotiable document) was made effective against third parties before the earlier of: (a) the time the asset became covered by the negotiable document; and (b) the time when an agreement was made between the grantor of the security right and the secured creditor in possession of the negotiable document providing for the asset to be covered by the negotiable document, so long as the asset became so covered within a specified short period of time (such as 30 days) from the date of the agreement. In this particular case, the normal first-in-time priority rule would apply and the first creditor to make its security in the tangible assets effective against third parties (whether directly or through taking a security right in a negotiable document representing those assets) will have priority. This exception provides a level of protection for holders of security rights in tangible assets other than inventory against situations in which the grantor, without notifying such holders and without their authorization, causes the assets to be covered by a negotiable document. For these reasons, the *Guide* also recommends that such an exception be adopted (see recommendation 109, second sentence).

C. Recommendations 76-109

Purpose

The purpose of provisions on the priority of a security right is:

- (a) To provide rules for determining the priority of a security right as against the rights of competing claimants in a predictable fair and efficient way; and
- (b) To facilitate transactions by which a grantor may create more than one security right in the same asset and thereby use the full value of its assets to obtain credit.

1. General recommendations

Priority between security rights granted by the same grantor in the same encumbered asset

76. The law should provide that priority between competing security rights granted by the same grantor in the same encumbered asset is determined as follows:

(a) As between security rights that were made effective against third parties by registration of a notice, priority is determined by the order of registration, regardless of the order of creation of the security rights;

(b) As between security rights that were made effective against third parties otherwise than by registration, priority is determined by the order of third-party effectiveness; and

(c) As between a security right that was made effective against third parties by registration and a security right that was made effective against third parties otherwise than by registration, priority is determined (regardless of when creation occurs) by the order of registration or third-party effectiveness, whichever occurs first.

This recommendation is subject to the rules provided in recommendations 77, 78 and 87-109, as well as in recommendations 178-185 (chapter IX on acquisition financing, option A: unitary approach).

Priority of a security right registered in a specialized registry or noted on a title certificate

77. The law should provide that a security right in an asset that is made effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 38 (chapter III on the effectiveness of a security right against third parties), has priority as against:

(a) A security right in the same asset with respect to which a notice is registered in the general security rights registry or which is made effective against third parties by a method other than registration in a specialized registry or notation on a title certificate, regardless of the order; and

(b) A security right in the same asset that is subsequently registered in the specialized registry or noted on a title certificate.

78. The law should provide that, if an encumbered asset is transferred, leased or licensed and, at the time of transfer, lease or licence, a security right in that asset is effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 38 (chapter III on the effectiveness of a security right against third parties), the transferee, lessee or licensee takes its rights subject to the security right, except as provided in recommendations 80-82. However, if the security right has not been made effective against third parties by registration in a specialized registry or notation on a title certificate, a transferee, lessee or licensee takes its rights free of the security right.

Priority of rights of transferees, lessees and licensees of an encumbered asset

79. The law should provide that, if an encumbered asset is transferred, leased or licensed and a security right in that asset is effective against third parties at the time of the transfer, lease or licence, a transferee, lessee or licensee takes its rights subject to the security right except as provided in recommendations 78 and 80-82.

80. The law should provide that:

(a) A security right does not continue in an encumbered asset that the grantor sells or otherwise disposes of, if the secured creditor authorizes the sale or other disposition free of the security right; and

(b) The rights of a lessee or licensee of an encumbered asset are not affected by a security right if the secured creditor authorizes the grantor to lease or license the asset unaffected by the security right.

81. The law should provide that:

(a) A buyer of a tangible asset (other than a negotiable instrument or negotiable document) sold in the ordinary course of the seller's business takes free of a security right in the asset, provided that, at the time of the sale, the buyer does not have knowledge that the sale violates the rights of the secured creditor under the security agreement;

(b) The rights of a lessee of a tangible asset (other than a negotiable instrument or document) leased in the ordinary course of the lessor's business are not affected by a security right in the asset, provided that, at the time of the conclusion of the lease, the lessee does not have knowledge that the lease violates the rights of the secured creditor under the security agreement; and

(c) The rights of a non-exclusive licensee of an intangible asset licensed in the ordinary course of the licensor's business are not affected by a security right in the asset, provided that, at the time of the conclusion of the licence agreement, the licensee does not have knowledge that the licence violates the rights of the secured creditor under the security agreement.

82. The law should provide that, if a transferee acquires a right in an encumbered asset free of a security right, any person that subsequently acquires a right in the asset from the transferee also takes its right free of the security right. If the rights of a lessee or licensee are not affected by a security right, the rights of a sub-lessee or sub-licensee are also unaffected by the security right.

Priority of preferential claims

83. The law should limit, both in type and amount, preferential claims arising by operation of law that have priority as against security rights and, to the extent preferential claims exist, they should be described in the law in a clear and specific way.

Priority of rights of judgement creditors

84. The law should provide that a security right has priority as against the rights of an unsecured creditor, unless the unsecured creditor, under other law, obtained a judgement or provisional court order against the grantor and took the steps necessary to acquire rights in the encumbered asset by reason of the judgement or provisional court order before the security right was made effective against third parties. The priority of the security right extends to credit extended by the secured creditor:

(a) Before the expiry of [a short period of time to be specified] days after the unsecured creditor notified the secured creditor that it had taken the steps necessary to acquire rights in the encumbered asset; or

(b) Pursuant to an irrevocable commitment (in a fixed amount or an amount to be fixed pursuant to a specified formula) of the secured creditor to extend credit, if the commitment was made before the unsecured creditor notified the secured creditor that it had taken the steps necessary to acquire rights in the encumbered asset.

This recommendation is subject to the exception in recommendation 183 (chapter IX on acquisition financing, option A: unitary approach).

Priority of rights of persons providing services with respect to an encumbered asset

85. The law should provide that, if other law gives rights equivalent to security rights to a creditor that has provided services with respect to an encumbered asset (for example, by repairing, storing or transporting it), such rights are limited to the asset in the possession of that creditor up to the reasonable value of the services rendered and have priority as against security rights in the asset that were made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter III on the effectiveness of a security right against third parties).

Priority of a supplier's reclamation right

86. The law should provide that, if other law provides that a supplier of tangible assets has the right to reclaim them, the right to reclaim is subordinate to a security right that was made effective against third parties before the supplier exercised its right.

Priority of a security right in an attachment to immovable property

87. The law should provide that a security right or any other right (such as the right of a buyer or lessee) in an attachment to immovable property that is created and made effective against third parties under immovable property law, as provided in recommendations 21 (chapter II on the creation of a security right) and 43 (chapter III on the effectiveness of a security right against third parties), has priority as against a security right in that attachment that is made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter III on the effectiveness of a security right against third parties).

88. The law should provide that a security right in a tangible asset that is an attachment to immovable property at the time the security right is made effective against third parties or that becomes an attachment to immovable property subsequently, which is made effective against third parties by registration in the immovable property registry as provided in recommendation 43 (chapter III on the effectiveness of a security right against third parties), has priority as against a security right or any other right (such as the right of a buyer or lessee) in the related immovable property that is registered subsequently in the immovable property registry.

Priority of a security right in an attachment to a movable asset

89. The law should provide that a security right or any other right (such as the right of a buyer or lessee) in an attachment to a movable asset that is made effective against third parties by registration in a specialized registry or by notation on a title certificate as provided in recommendation 42 (chapter III on the effectiveness of a security right against third parties) has priority as against a security right or other right in the related movable asset that is subsequently registered in the specialized registry or noted on the title certificate.

Priority of a security right in a mass or product

90. The law should provide that, if two or more security rights in the same tangible asset continue in a mass or product as provided in recommendation 22 (chapter II on the creation of a security right), they retain the same priority as the security rights in the asset had as against each other immediately before the asset became part of the mass or product.

91. The law should provide that, if security rights in separate tangible assets continue in the same mass or product and each security right is effective against third parties, the secured creditors are entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of the respective security rights. For purposes of this formula, the maximum value of a security right is the lesser of the value determined pursuant to recommendation 22 (chapter II on the creation of a security right) and the amount of the secured obligation.

92. The law should provide that an acquisition security right in a separate tangible asset that continues in a mass or product and is effective against third parties has priority as against a security right granted by the same grantor in the mass or product.

Irrelevance of knowledge of the existence of a security right

93. The law should provide that knowledge of the existence of a security right on the part of a competing claimant does not affect priority.¹

Subordination

94. The law should provide that a competing claimant entitled to priority may at any time subordinate its priority unilaterally or by agreement in favour of any other existing or future competing claimant.

Impact of continuity in third-party effectiveness on priority

95. The law should provide that, for the purpose of recommendation 76, the priority of a security right is not affected by a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

96. The law should provide that, if a security right is covered by a registered notice or made effective against third parties and subsequently there is a period during which the security right is neither covered by a registered notice nor effective against third parties, the priority of the security right dates from the earliest time thereafter when the security right is either covered by a registered notice or made effective against third parties.

Priority of security rights securing existing and future obligations

97. The law should provide that, subject to recommendation 84, the priority of a security right extends to all secured obligations, regardless of the time when they are incurred.

Extent of priority

98. The law should provide that, if a State implements recommendation 57, subparagraph (d) (chapter IV on the registry system), the priority of the security right is limited to the maximum amount set out in the registered notice.

Application of priority rules to a security right in a future asset

99. The law should provide that, for purposes of recommendation 76, subparagraphs (a) and (c), the priority of a security right extends to all encumbered assets covered by the registered

¹As for the impact of knowledge that a transaction violates the rights of a secured creditor, see recommendations 81, 102, subparagraph (b), 105 and 106.

notice, irrespective of whether they are acquired by the grantor or come into existence before, at or after the time of registration.

Application of priority rules to a security right in proceeds

100. The law should provide that, for purposes of recommendation 76, the time of third-party effectiveness or the time of registration of a notice as to a security right in an encumbered asset is also the time of third-party effectiveness or registration as to a security right in its proceeds.

2. Asset-specific recommendations

Priority of a security right in a negotiable instrument

101. The law should provide that a security right in a negotiable instrument that is made effective against third parties by possession of the instrument, as provided in recommendation 37 (chapter III on the effectiveness of a security right against third parties), has priority as against a security right in a negotiable instrument that is made effective against third parties by any other method.

102. The law should provide that a security right in a negotiable instrument that is made effective against third parties by a method other than possession of the instrument is subordinate to the rights of a secured creditor, buyer or other transferee (by agreement) that:

- (a) Qualifies as a protected holder under the law governing negotiable instruments; or
- (b) Takes possession of the negotiable instrument and gives value in good faith and without knowledge that the transfer is in violation of the rights of the secured creditor under the security agreement.

Priority of a security right in a right to payment of funds credited to a bank account

103. The law should provide that a security right in a right to payment of funds credited to a bank account that is made effective against third parties by control, as provided in recommendation 49 (chapter III on the effectiveness of a security right against third parties), has priority as against a competing security right that is made effective against third parties by any other method. If a depositary bank concludes control agreements with more than one secured creditor, priority among those secured creditors is determined according to the order in which the control agreements are concluded. If the depositary bank is the secured creditor, its security right has priority as against any other security right (including a security right made effective against third parties by a control agreement with the depositary bank even if the depositary bank's security right is later in time) except a security right of a secured creditor that obtains control by becoming the account holder.

104. The law should provide that a right under other law of a depositary bank to set off obligations owed to the depositary bank by the grantor against the grantor's right to payment of funds credited to a bank account has priority as against a security right in the right to payment of funds credited to a bank account except a security right of a secured creditor that obtains control by becoming the account holder.

105. The law should provide that, in the case of a transfer of funds from a bank account initiated by the grantor, the transferee of the funds takes free of a security right in the right to payment of funds credited to the bank account, unless the transferee has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not adversely affect the rights under other law of transferees of funds from bank accounts.

Priority of a security right in money

106. The law should provide that a person that obtains possession of money that is subject to a security right takes the money free of the security right, unless that person has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not adversely affect the rights under other law of holders of money.

Priority of a security right in a right to receive the proceeds under an independent undertaking

107. The law should provide that a security right in a right to receive the proceeds under an independent undertaking that is made effective against third parties by control has priority as against a security right made effective against third parties pursuant to recommendation 48 (chapter III on the effectiveness of a security right against third parties). If control has been achieved by acknowledgement and inconsistent acknowledgements have been given to more than one secured creditor by a person, priority among those security rights is determined according to the order in which the acknowledgements were given.

Priority of a security right in a negotiable document or a tangible asset covered by a negotiable document

108. The law should provide that a security right in a negotiable document and the tangible assets covered thereby is subordinate to any superior rights acquired by a transferee of the document under the law governing negotiable documents.

109. The law should provide that a security right in a tangible asset made effective against third parties by possession of a negotiable document has priority as against a competing security right made effective against third parties by another method. This rule does not apply to a security right in an asset other than inventory if the security right of the secured creditor not in possession of the negotiable document was made effective against third parties before the earlier of:

- (a) The time that the asset became covered by the negotiable document; and
- (b) The time when an agreement was made between the grantor and the secured creditor in possession of the negotiable document providing for the asset to be covered by a negotiable document so long as the asset became so covered within [a short period of time to be specified] days from the date of the agreement.

VI. Rights and obligations of the parties to a security agreement

A. General remarks

1. Introduction

1. A security agreement sets out the understanding between the grantor and the secured creditor. As a contract, it is subject to the general contract law of a State dealing with issues such as the formation, interpretation, effects, breach, avoidance and enforcement of contracts. However, in view of the particular objects and purposes of security agreements, States normally enact special, additional rules regulating their formation and effects. These rules usually provide, for example, for a relatively comprehensive regime governing the third-party effects of a security agreement, while leaving most of the *inter partes* effects to be determined contractually by the grantor and the secured creditor under the principle of party autonomy (see recommendation 10).

2. The substantive content of a security agreement will vary according to the needs and wishes of the parties. Typically, clauses in security agreements address three main themes. First, some provisions are included in the agreement because they form part of the mandatory requirements for creating a security right. For example, rules relating to the description of the encumbered assets and the secured obligation would fall into this category. In chapter II on the creation of a security right, the *Guide* recommends that these mandatory requirements for a security agreement to be effective as between the parties should be minimal and easy to satisfy (see recommendations 13-15).

3. Second, the standard security agreement will also contain various terms specifying the rights and obligations of the parties once the agreement has become effective between them. Many of these terms deal with the consequences of a default by the grantor or the breach of an obligation by the secured creditor. Often the events constituting a default by the grantor and the remedies available to the secured creditor to enforce the terms of the security agreement are enumerated at length. The significant impact that enforcement may have on the rights of third parties usually has led States to specify in some detail a series of mandatory rules governing default and enforcement (see chapter VIII on the enforcement of a security right). These mandatory rules normally aim at protecting the rights of grantors and third parties. As mandatory rules, they will necessarily override any terms of a security agreement that specify conflicting creditor rights and remedies. In some legal systems, however, the benefit of these mandatory rules may be waived by the grantor after default (see recommendation 133) or by the secured creditor at any time (see recommendation 134). Where there is no conflict between the terms of the security agreement and mandatory rules, or where the security agreement provides even greater protection to the debtor or third parties than mandatory rules (for example, by giving the grantor or third parties a right to reinstate the agreement after a default), the terms set out in the security agreement will govern the post-default relationship between the parties.

4. Third, security agreements usually contain a series of provisions meant to regulate aspects of the relationship between the parties after creation but prior to default. Efficiency and predictability in secured transactions often call for additional detailed clauses to govern ongoing aspects of the transaction. Many States actively encourage the parties to fashion the terms of the security agreement to meet their own requirements. Nonetheless, as in the case of post-default rights and obligations, these same States also frame various mandatory rules relating to pre-default rights and obligations, especially when third-party rights may be affected. This said, in order to offer grantors and secured creditors maximum flexibility to tailor their agreement to fit their needs, States usually keep these mandatory pre-default rules to a minimum.

5. While States are generally reluctant to impose a full menu of mandatory rules governing the pre-default rights and obligations of the grantor and the secured creditor, they do have an interest in providing guidance to grantors and secured creditors. Indeed, many States enact a greater or lesser number of non-mandatory rules that are applicable if the parties do not specify otherwise in their security agreement. This chapter does not address all the situations where States may wish to elaborate such non-mandatory rules. Rather, it offers only an indicative and non-exhaustive list of those non-mandatory pre-default rules that are commonly found in contemporary national legislation.

6. The discussion that follows focuses on three policy issues. The first, examined in section A.2, relates to the principle of party autonomy and the extent to which parties should be free to fashion the terms of their security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second, explored in section A.3, relates to the mandatory rules that should govern pre-default rights and obligations of grantors and secured creditors. The third, which is the subject of sections A.4 and A.5, concerns the type of non-mandatory rule that could be included in modern secured transactions legislation.

7. Section B of this chapter considers various mandatory and non-mandatory rules to deal with pre-default rights and obligations in relation to particular types of asset and transaction. The chapter concludes, in section C, with a series of recommendations.

2. *Party autonomy*

(a) *General*

8. In chapter I on the scope of application, the *Guide* announces the principle of party autonomy as one of the foundations of its basic approach to secured transactions (see recommendation 10). In most States, this principle forms part of the general law of contracts and it is applicable to secured transactions law simply because a security agreement is a contract. The central idea is that, unless a State provides otherwise, the secured creditor and the grantor should be free to craft their security agreement as they see fit. While party autonomy gives credit providers significant power in determining the content of the security agreement, the expectation is that permitting the secured creditor and the grantor to structure their transaction and allocate pre-default rights and obligations as best suited to their objectives will normally permit grantors to gain wider access to secured credit.

9. The party autonomy principle has two distinct dimensions when applied to pre-default rights and obligations. The first is aimed at States. While States should be free to enact mandatory rules to govern key features of the ongoing relationship between parties, their number should be limited and their scope clearly stated. The second is directed to the effects that a grantor and a secured creditor seek to achieve through their agreement. Any terms that derogate from or modify non-mandatory rules or that speak to issues not addressed by a State's non-mandatory rules only bind the parties themselves and, except to the extent provided by general principles of contract law, do not affect the rights of third parties.

10. Legislative limitations on party autonomy in the form of mandatory rules can be found both within a secured transactions law and in other laws. Many States have adopted consumer-protection laws that extensively regulate consumer transactions, often strictly constraining the capacity of secured creditors and grantors to design their own regime of pre-default rights and obligations. An example would be a rule that prohibits secured creditors from limiting the right of consumer grantors to sell or dispose of the encumbered assets. Likewise, many States have enacted family law statutes that significantly restrict party autonomy where "family property" or "community property" is at issue. An example would be a rule that prevents secured creditors from limiting the use to which grantors may put such "family property". The *Guide* recommends that, while secured transactions law should apply to security rights created or acquired by consumers, the rights of consumers under consumer-protection law should not be affected (see chapter I on the scope of application of the *Guide*, para. 11 and recommendation 2, subparagraph (b)).

11. In addition to these mandatory rules governing particular grantors and particular assets that are set out in other laws, it is common for States to impose various mandatory rules of a more general character. These rules are usually found in secured transactions legislation and most often relate to default and enforcement (for example, the standard of conduct in the case of enforcement cannot be waived unilaterally or varied by agreement; see recommendation 132). However, some of these rules also concern pre-default rights and obligations (for example, the party in possession must take reasonable care of the encumbered assets and return them and terminate any registered notice upon full payment of the secured obligation; see recommendations 111 and 112). These latter types of pre-default mandatory rule are discussed in the next section of this chapter.

12. Because party autonomy is the basic principle, the secured creditor and the grantor will often set out in detail a number of structural elements of their agreement. For example, the following items are frequently specified:

(a) The asset to be encumbered and the conditions under which an asset that is not initially encumbered may later become encumbered;

(b) The obligation to be secured under the agreement (including future obligations);

(c) What the grantor is permitted to do or prohibited from doing with the encumbered assets (including whether the grantor has the right to use, transform, collect fruits and revenues from, and dispose of, the assets);

(d) If and how the secured creditor may obtain possession of the encumbered asset prior to default, and the rights and duties of the creditor with respect to an encumbered asset in its possession;

(e) A series of representations made and obligations undertaken by the grantor with respect to the encumbered asset, such as the obligation to maintain the asset in a good state of repair, to keep it insured against loss and to inform the secured creditor if a statutory right is asserted against the asset; and

(f) The events triggering default (primarily of the grantor, but also of the secured creditor) under the agreement.

13. It is against this background of party autonomy and its usual scope as reflected in the security agreement that the various mandatory and non-mandatory rules outlined below should be read.

(b) *Source of rights and obligations of the parties*

14. Most of the mandatory and non-mandatory rules pertaining to the pre-default rights and obligations of parties relate to the manner in which the prerogatives and responsibilities of ownership are allocated between the grantor and the secured creditor. Consistent with the principle of party autonomy and subject to any appropriate limitations (see paras. 9-11 above), most States take the position that the parties themselves should determine their mutual pre-default rights and obligations. Hence, it is important to determine the source of these rights and obligations.

15. In principle, these rights and obligations are determined by the specific terms and conditions that the parties have included in their agreement. This would also include any general conditions (for example, the implied clauses that are often enumerated in insurance legislation) that the parties incorporate into their agreement by reference. In addition, the national law of most States provides that, because the security agreement may refer to an ongoing relationship between the parties that is common in a particular industry or field, they should be bound by any usages to which they have agreed. Finally, unless the parties agree otherwise, in performing their agreement they should be bound by any practices they have established between themselves. The *Guide* adopts the idea that the agreement between the parties is the primary source of their mutual rights and obligations, together with any usages to which they have agreed and, absent a contrary agreement, their own established practices (see recommendation 110).

3. *Mandatory pre-default rules*

(a) *General*

16. Mandatory rules relating to pre-default rights and obligations of the parties may be found both in secured transactions law and in other laws. Generally, these rules are of three broad types. One type, which, as already noted (see para. 10 above), States usually enact in consumer-protection or family property legislation, has a very particular scope and application. The *Guide* recognizes the importance that States may attach to these matters (see recommendation 2, subparagraph (b)). In order to achieve the maximum economic benefit from a secured transactions regime, however, States should clearly specify the scope of these limitations on the parties' freedom to tailor pre-default rights and obligations to their needs and wishes.

17. Other pre-default mandatory rules focus on the substantive content that parties may include in their agreement. Usually these rules are conceived as general limitations on the rights of secured creditors and are applicable whether the grantor is a consumer or an enterprise. They can vary widely from State to State. For example, in the case of certain security agreements by which the secured creditor obtains a security right in all assets of a grantor (such as an enterprise mortgage), some States have legislated a carve-out for unsecured creditors in the insolvency context. Some States do not permit creditors to restrict the right of a grantor to use or transform the encumbered assets as long as the use or transformation being undertaken is consistent with the nature and purpose of those assets. Some States do not permit a secured creditor either to use or to apply against the secured obligation the natural and civil fruits or revenues generated by encumbered assets in its possession.

18. Because of the importance that the *Guide* attaches to the principle of party autonomy, it takes the position that States generally ought not to enact pre-default mandatory rules that restrict the number or nature of the obligations that secured creditors and grantors may require of each other. Still, the above concerns are often real and, depending on the particular character of their national economy or the commercial enterprise granting the security right, States may feel the need to regulate more closely the pre-default relationship between grantors and secured creditors. Should they do so, however, in order to avoid unnecessary general limitations on party autonomy, such mandatory rules should: (a) be expressed in clear language; (b) be drafted in precise and limitative, rather than open-ended, terms; and (c) like similar rules in the post-default context, be based on recognized grounds of public policy such as good faith, fair dealing and commercial reasonableness (see recommendations 131 and 132).

19. A third type of pre-default mandatory rule aims at ensuring that the fundamental purposes of a secured transactions regime are not distorted. Typically, States deploy mandatory rules of this type to impose minimum duties upon the party that has possession or control of the encumbered assets. Thus, for example, since one of the central purposes of a security right is to provide a creditor with priority, upon default, to payment of money generated by the sale of encumbered assets, it would be consistent with this purpose that grantors be obligated to preserve the assets so that their economic value is not dissipated. This obligation would embrace, notably, the duty not to waste the encumbered assets or otherwise allow them to deteriorate beyond what would be expected from normal usage, thereby preserving the economic value of the assets.

20. Rules requiring the grantor and, in the case where the secured creditor has possession, the secured creditor to take reasonable care of the encumbered assets, and more generally rules directed to preserving the encumbered assets, are meant to encourage responsible behaviour by parties to a security agreement. These types of mandatory rule are not, however, identical in impact to consumer-protection rules or mandatory rules stipulating the substantive content of a security agreement. The latter types of mandatory rule are constitutive of the security right itself and cannot be waived either at the time the agreement is negotiated or afterwards. States usually take a more nuanced approach to mandatory pre-default rules established within the secured transactions regime.

21. The basic rule in most legal systems is that parties may not, by agreement, derogate from mandatory rules setting out their general pre-default rights and obligations. For

example, States typically do not permit parties to contract out of their duty to take reasonable care of the encumbered assets. However, this does not always preclude parties from waiving a breach of the duty after the fact. Many States provide that the secured creditor may later release the grantor from its pre-default obligations (including obligations imposed by mandatory rules) or may waive its rights resulting from the grantor's default. By contrast, given the usual dynamic between a secured creditor and a grantor, many of these same States take the position that the grantor should not be allowed to release the secured creditor before default from observing any duties imposed on the secured creditor by mandatory rules.

22. The mandatory pre-default rules recommended in the *Guide* aim at policy objectives consistent with what have been defined as the core principles of an effective and efficient regime of secured transactions (see recommendation 1). They set out pre-default rights and obligations that: (a) encourage parties in possession to preserve the encumbered assets; and (b) ensure that once the secured obligation is paid or otherwise performed, the grantor recovers the full use and enjoyment of the previously encumbered assets.

23. Chapter IX of the *Guide* on acquisition financing envisages that some States might choose to preserve retention-of-title and financial lease transactions as independent techniques of acquisition financing. In the case of a sale until full payment of the purchase price, and in the case of a financial lease for the duration of the transaction, the seller's or lessor's right is not a security right but rather the seller's or lessor's right to assert its ownership of the assets. For this reason, even though the fundamental economic objectives of these transactions are identical to those of an ordinary acquisition security right, the mandatory rules concerning pre-default rights and obligations of the parties will have to be framed in slightly different language in order to achieve the same policy outcome. Thus, for example, the seller that retains ownership should not be able to avoid its obligations to refrain from engaging in transactions with third parties that prejudice the rights of a buyer that is not in default. In a like manner, the buyer that has possession of an asset but only an expectancy of ownership should not be able to avoid its responsibility to preserve the asset. These necessary adjustments are discussed in chapter IX, section A.9.

(b) *Duty to preserve the encumbered assets*

24. The encumbered asset is one of the creditor's principal assurances of repayment of the secured obligation. It is also an asset that the grantor normally expects and intends to continue using freely once the loan or credit has been repaid. For these reasons, both grantors and secured creditors have an interest in preserving encumbered assets.

25. Most often the person that has possession of an encumbered asset will be in the best position to ensure its preservation. This explains why States normally impose the duty to take reasonable care of the encumbered asset on that party. Only by exception, and almost invariably in relation to intangible assets, might a person not in notional possession be optimally positioned to care for the encumbered asset. In view of the objective of ensuring a fair allocation of responsibility for caring for encumbered assets and encouraging parties to preserve them, it matters little whether it is the grantor or the secured creditor that has possession. The mandatory duty imposed on the person in possession to preserve the encumbered asset should be identical in both cases.

26. The specific content of the duty may vary considerably, depending on the nature of the encumbered asset. In the case of tangible assets, the duty points first to the physical preservation of the asset. Where inanimate tangible assets are concerned, this usually would include a duty to keep these assets in a good state of repair and not to use them for a purpose other than that which is normal in the circumstances. For example, if the encumbered asset is a piece of machinery, it must not be left out in the rain. Moreover, the party that possesses and uses it must perform routine maintenance. Still again, if security is taken, for example, on a passenger automobile, the person in possession, who is authorized to use it, cannot then use the vehicle as a light truck for commercial purposes.

27. Where the encumbered assets are inventory, the duty of preservation may require other, more onerous, actions on the part of the person in possession. Unlike equipment, inventory is often on display and is easier to steal. Hence the grantor (that is, the party most likely to be in possession) must provide adequate security to forestall “shrinkage” and must properly display the inventory to avoid breakage or store it so as to prevent deterioration. For example, if the inventory consists of expensive electronic equipment, or particularly fragile glassware, it may be necessary to keep it in locked cases; if it consists of perishable foodstuffs, the person in possession would have to store the encumbered assets in refrigerated units.

28. In the case of living tangible assets such as animals, the duty should be similar. It is not enough simply to keep the animal alive. The person in possession must ensure that the animal is properly fed and is maintained in good health (for example, receives adequate veterinary care). Where the animal requires special services to preserve it in good condition (for example, proper exercise for a racehorse, regular milking for a cow), the duty of care extends to providing these services. Finally, as with equipment, the duty also means that the animal cannot be used for abnormal purposes. Thus, if the value of a prize bull lies in stud fees, it cannot be used as a beast of burden.

29. If the encumbered asset consists of a right to payment of money embodied in a negotiable instrument, the duty will certainly include the physical preservation of the document. In such a case, however, the duty of care will include taking the necessary steps to maintain or preserve the grantor’s rights against prior parties bound under the negotiable instrument (such as presenting the instrument, protesting it if required by law, and providing notice of dishonour). It may also be incumbent upon the person in possession of a negotiable instrument to avoid loss of rights on the instrument itself against prior parties by taking steps against persons secondarily liable under the instrument (such as guarantors). Where the tangible asset is a negotiable document, here also the person in possession must physically preserve the document. Moreover, should the document be time-limited, the person in possession of the document must present it prior to expiry to claim physical possession of the assets covered by the document.

30. Where the encumbered asset is intangible, it is more difficult to specify the duty to take reasonable care by reference to the person in possession. Frequently, the intangible asset is a simple contractual right to receive payment. The character of the duty of preservation in such cases is discussed below in section B. Where the encumbered asset is a right to payment of funds credited to a bank account, intellectual property or a right to receive the proceeds under an independent undertaking, States typically provide for the respective rights and obligations of parties to the transaction in special legislation regulating that particular form of asset.

31. In determining the extent of the obligation of the person in possession to preserve encumbered assets, States are making a cost-benefit judgement in terms of how best to ensure a fair allocation of responsibility for their preservation. The main policy issue is to avoid placing an undue burden on the person in possession. In line with the above considerations, the *Guide* recommends that States enact a general mandatory pre-default rule imposing a duty on all parties in possession to take reasonable care to preserve encumbered assets (see recommendation 111).

(c) *Duty to preserve the value of encumbered assets*

32. In many cases, the physical preservation of the encumbered asset will also ensure the maintenance of its value. Sometimes, however, additional steps will be necessary to achieve this outcome. The special case of intangible assets is discussed below in section B. As for tangible assets, States typically distinguish between the obligations of grantors and the obligations of secured creditors. Since the encumbered asset is the secured creditor's guarantee of payment, grantors are occasionally required to take positive action to maintain the value of an encumbered asset over and above the obligation to preserve it physically. For example, grantors may be required to install computer upgrades or return equipment to a dealer for service under a recall order. Once again, in determining the extent of this obligation on grantors, States must weigh the benefits against the burdens they impose.

33. Some States do not impose any obligation related to preservation of the value of encumbered assets on secured creditors in possession. The rationale is that, if the imposition of an obligation requires secured creditors to assume a burdensome responsibility for closely monitoring encumbered assets, the asset will simply cease to have value as security, to the detriment of the grantor. This is particularly the case with respect to intangible assets. For example, secured creditors should not be required to take any steps to maintain the market value of a trademark, or to engage in investment analysis to maintain the value of a stock portfolio. In any event, it is always in the grantor's interest that the encumbered asset maintains its value so that parties will normally provide that grantors may indicate to secured creditors in possession the steps to be taken to preserve value in such cases. Any money expended to do so will typically either be paid in advance by the grantor or added to the secured obligation.

34. Other States, by contrast, do impose on secured creditors as well as grantors in possession a specific obligation to preserve the value of encumbered assets, in cases where preservation of the encumbered tangible asset is not, of itself, sufficient to ensure the preservation of the value of the asset. Typically, States do not, however, specify the content of these duties, leaving it to the parties to enumerate in their security agreement the additional duties that aim at this objective. The assumption is that secured creditors and grantors generally will know best what steps should be taken with respect to individual assets and they should be free to contract for these obligations as they see fit. The advantage of this position is that, while recognizing the importance of preserving the value of tangible assets against undue depreciation in value, States authorize parties to agree between themselves what reasonable steps should be taken in the particular circumstances of each case. In line with this general tendency, the *Guide* recommends that States enact a mandatory pre-default rule requiring parties in possession of tangible encumbered assets

to take reasonable steps to preserve the pre-default value of the assets, but does not make any recommendation as to a more specific standard that States should adopt for this purpose (see recommendation 111).

(d) *Duty to return the encumbered assets and to terminate a registered notice*

35. The central purpose of a security right is to enhance the likelihood that the secured obligation will be satisfied, either by encouraging the grantor to repay the secured obligation or by the application of the value of the encumbered asset to the secured obligation. A security right is not a means of expropriating surplus value from the grantor or a disguised transfer of the encumbered assets to the creditor. Upon satisfaction of the secured obligation, as a matter of law, the security right terminates and the grantor is entitled to possession and full enjoyment of unencumbered ownership of the previously encumbered assets. To implement the grantor's rights, most States enact mandatory rules to regulate the duties of the secured creditor once the secured obligation has been repaid in full and all credit commitments have been terminated. These duties are of two types. Some duties relate to the return of the encumbered assets to the grantor in situations where the secured creditor is in possession of the assets at the time the secured obligation has been fully satisfied; other duties relate to taking steps to enable the grantor to enjoy its right to the encumbered assets free from any disability arising from the prior existence of the encumbrance.

36. The *Guide* contemplates that, in most cases, secured creditors may make their right effective against third parties by taking possession of the encumbered assets should they wish to do so (see recommendation 37). In addition, even when creditors achieve third-party effectiveness by registering a notice rather than by taking possession, given the principle of party autonomy, grantors may nonetheless permit secured creditors to take possession of the encumbered assets. This permission may be given either at the time of creating the security right or at some time thereafter. In the latter case, the grantor need not even be in default under the security agreement. Regardless of how it arises, the secured creditor's possession is grounded in the agreement between the parties and relates to the objectives of that agreement.

37. Since a security right is intended to ensure the performance of an obligation, once that performance has occurred, the grantor should be able to recover either possession of the encumbered assets or unimpeded access to them, or both. This explains the formal duty that many States impose on secured creditors to return the encumbered assets to the grantor upon full payment of the secured obligation and termination of all credit commitments. In these States, the burden lies on the creditor to deliver the encumbered assets, and not on the grantor to reclaim them or to take them away. In other States, the secured creditor has no obligation to deliver, but need only permit the grantor to reclaim previously encumbered assets. Where tangible assets are in the hands of a third party that was initially holding the assets on behalf of the grantor, but that upon the creation of the security right is holding on behalf of the secured creditor, many States require the secured creditor to indicate to the person in possession that the secured obligation has been paid and that the possessor is once again holding the assets exclusively on behalf of the grantor. A similar duty arises in many States where the secured creditor and a deposit-taking institution have entered into a control agreement. In these States, the secured creditor is usually obliged to inform specifically the depositary that the control agreement is no longer

in effect. These various requirements are all intended to implement the grantor's right to enjoy the free use of encumbered assets once the secured obligation has been paid in full and all credit commitments have been terminated.

38. Some States consider that the secured creditor must also take positive steps to ensure that the grantor is placed in the same position that it occupied prior to the creation of the security right. In the case of intangible assets, this would require sending a notice to any third-party obligor (for example, the debtor of a receivable) indicating that the secured obligation has been paid in full and that the grantor is again entitled to receive payment of the obligation. More generally, some States oblige secured creditors to release the encumbered assets from the security right and, in cases where third-party effectiveness has been achieved by registration, to take steps to cancel the effectiveness of the notice relating to that security right on the record of the relevant registry. Thus, for example, where registrations are not automatically purged from a registry after a relatively short period of time, these States impose upon creditors a duty to request cancellation of the registration. Similarly, where the security right has been made the subject of a notation on a title certificate, some States oblige the secured creditor to take steps to ensure that the notation is deleted from the title certificate. The unifying theme of these requirements is that the secured creditor should take steps to remove any formal evidence of its previous right that might lead third parties to think that the grantor's assets are still potentially subject to the security right.

39. The mandatory rule recommended in the *Guide* to govern the relationship of the parties once the secured obligation has been paid broadly reflects the above considerations (see recommendation 112). Its primary objective is to make certain that the grantor recovers the full use and enjoyment of the previously encumbered assets and is able to deal effectively with them in transactions involving third parties, free of any disability arising from the no-longer-extant security right. Where achieving this outcome requires the cancellation of a notice in the general security rights registry, the *Guide* recommends that the grantor be entitled to compel the secured creditor to do so or, under certain conditions, may do so itself (see recommendation 72).

4. Non-mandatory pre-default rules

40. In addition to various mandatory rules governing pre-default rights and obligations of the parties, most States have developed a longer or shorter list of non-mandatory rules addressing other pre-default issues. The vocabulary used to identify these non-mandatory rules that are "subject to contrary agreement between the parties" varies from State to State (for example, *jus dispositivae*, suppletive rules or default rules). Their common feature, however, is this: they are meant to apply automatically as additional terms to the security agreement unless there is evidence that the parties intended to exclude or modify them.

41. Different policy rationales are offered to support the idea of non-mandatory rules. Some States use non-mandatory rules to protect weaker parties on the theory that they provide a baseline against which the stronger party may attempt to negotiate an alternative contractual provision. Other States conceive them as rules simply mirroring the terms of an agreement that parties probably would have negotiated had they turned their attention

to particular points. The *Guide* takes the position that the true justification for non-mandatory rules lies in the fact that they can be used to promote policy objectives consistent with the logic of a secured transactions regime. Examples of non-mandatory rules grounded in this rationale are not hard to find. The law in many States provides that, unless the parties agree otherwise, the grantor will deposit any insurance proceeds arising from the loss of or damage to the encumbered asset in a deposit account controlled by the secured creditor. In addition, the law in many States provides that, unless the parties agree otherwise, revenues deriving from the encumbered asset may be retained by the secured creditor during the life of the security agreement as additional encumbered assets, so that in case of default those revenues may be applied to the payment of the secured obligation. In view of this general objective, there are at least four reasons why States might choose to develop a panoply of non-mandatory rules.

42. First, by allocating rights and obligations between a secured creditor and a grantor in the manner to which they themselves would likely agree, a set of non-mandatory rules helps to reduce transaction costs, eliminating the need for the parties to negotiate and draft new provisions already adequately covered by these rules. Here, non-mandatory rules serve as implied or default terms (that is, terms applicable in the absence of agreement to the contrary) that, unless a contrary intention is expressed in the security agreement, are deemed to form part of that agreement. An example of such an implied term would be a rule that permits a secured creditor in possession of the encumbered asset to obtain any revenues produced by that asset and to apply them directly to the payment of the secured obligation.

43. Second, even the best-advised and most experienced parties do not possess infallible insight into the future. However carefully drawn up an agreement, there will be unforeseen circumstances. To obviate the need for a judicial or arbitral decision to fill these gaps in the agreement when they arise and to reduce the number of potential disputes, States usually provide for basic characterization rules. These non-mandatory rules direct parties to other, more general, legal principles that can be deployed to guide the resolution of unanticipated problems. An example of such a rule is that which provides that the grantor of a security right remains the holder of the substantive right (be it ownership, a lesser property right or a personal right) over which security has been taken. Thus, in working through any particular unforeseen event, the parties may begin with the principle that the exercise of any right not specifically allocated to the secured creditor remains vested in the grantor.

44. Third, a relatively comprehensive legislative elaboration of the rights and obligations of the parties before default increases efficiency and predictability by directing the attention of parties to issues that they should consider when negotiating their agreement. A series of default rules from which they may opt out can serve as a drafting aid, offering a checklist of points that might be addressed at the time the security agreement is finalized. Even when parties decide to modify the stated non-mandatory rules so as to achieve better their purposes, the exercise of having attended to them ensures that these matters are considered and not inadvertently left aside.

45. Finally, non-mandatory rules make it possible for the principle of party autonomy to operate most efficiently. This benefit is particularly evident in long-term transactions where the parties cannot anticipate every contingency. Such rules facilitate flexibility and

reduce compliance costs. For example, treating the agreement as complete in itself and requiring the parties to formalize all subsequent modifications and amendments to that agreement simply imposes additional transaction costs on the grantor. As these are non-mandatory rules, parties can always exclude their application by a specific contractual provision, such as a clause that provides that a written document contains the entire agreement of the parties and that it does not incorporate any implied terms.

46. The advantages of permitting the parties to define their relationship with the assistance of a set of non-mandatory rules are widely recognized by many national legal systems (for example, articles 2736-2742 of the Civil Code of Québec, Canada, and articles 9-207 to 9-210 of the Uniform Commercial Code in the United States), by organizations that promote regional model laws (for example, article 15 of the European Bank for Reconstruction and Development Model Law on Secured Transactions and article 33 of the Organization of American States Model Inter-American Law on Secured Transactions),¹ and by international conventions dealing with international sales (for example, article 6 of the United Nations Convention on Contracts for the International Sale of Goods (1980))² or some aspect of secured transactions in movable property (for example, article 11, paragraph 1, of the United Nations Assignment Convention and article 15 of the Convention on International Interests in Mobile Equipment).³

5. *Typical non-mandatory pre-default rules*

(a) *General*

47. This chapter does not address all of the situations where States may wish to develop non-mandatory rules. For example, it does not deal with any non-mandatory rules that may be developed in relation to additional terms that complete those required for a security right to exist (for example, the possible contents of the security agreement above the minimum necessary for creation). Non-mandatory rules in this context fulfil a different function and their desirability, scope and content would, therefore, be governed by different policy considerations. Moreover, and for the same reason, this chapter does not consider non-mandatory rules that are meant to govern post-default rights and obligations of the parties. These non-mandatory rules are addressed in chapter VIII on the enforcement of a security right.

48. The non-mandatory rules discussed in this section are those directed to pre-default rights and obligations of the parties once the security agreement has become effective between them. Because non-mandatory rules will usually reflect the needs, practices and policies of particular States, their specific configuration varies enormously. Still, there is a core of non-mandatory rules that are commonly found in contemporary national legislation. These are typically of two broad types: (a) rules that serve as a complement to mandatory rules dealing with the rights and duties of secured creditors in possession of encumbered assets; and (b) rules that set forth the rights retained by the grantor regardless of where possession lies.

¹See Introduction, footnotes 3 and 9.

²United Nations publication, Sales No. E.95.V.12.

³See Introduction, footnotes 7 and 8.

49. Like mandatory rules, these non-mandatory rules are meant to encourage responsible behaviour on the part of those having custody of encumbered assets. Hence, States usually organize them according to whether the secured creditor or the grantor has possession of the encumbered assets. Some non-mandatory pre-default rules, however, are intended to apply regardless of whether the secured creditor or the grantor is in possession. These situations are considered below in turn.

(b) Non-mandatory rules where the secured creditor is in possession

50. As already noted (see paras 24-31 above), most States have mandatory rules that require secured creditors in possession to take reasonable care of, to preserve and to maintain the encumbered assets in their possession. Typically, where the secured creditor has a right to use the encumbered assets, the secured creditor is also bound to undertake all necessary repairs to keep the assets in good working condition. The basic content of these mandatory rules has already been discussed (see paras. 16-39 above). In addition, some States enact a series of non-mandatory rules that specify further obligations of creditors to care for encumbered assets in their possession, especially in cases where the encumbered assets generate natural and civil fruits or revenues. The following paragraphs address the more common non-mandatory rules of this type.

51. Concerning the basic obligation of care and preservation, many States specifically require that the secured creditor keep the encumbered tangible assets clearly identifiable. If these assets are fungible and commingled with other assets of the same nature, this duty is transformed into an obligation to keep a sufficient quantity of assets of the same quality as those originally encumbered. In addition, where maintenance requires action beyond the creditor's personal capacity, States often require the creditor to notify the grantor and, if necessary, permit the grantor temporarily to take possession to repair, care for or preserve the asset or its value.

52. Where the encumbered asset consists of an instrument embodying the grantor's right to the payment of money, the obligation of care on the part of the secured creditor may not be limited to the physical preservation of that document. Many States oblige the secured creditor in possession of a negotiable instrument to avoid loss of rights on the instrument itself against prior parties by taking steps against persons secondarily liable under the instrument (such as guarantors). In these States, it is also common to provide that either the grantor or the secured creditor may sue to enforce the payment obligation.

53. A non-mandatory corollary to the secured creditor's obligation to take care of the encumbered asset is its entitlement to be reimbursed for reasonable costs expended to preserve the asset and to have these costs added to the secured obligation. In addition, many States permit the secured creditor to make reasonable use of or operate the encumbered asset (see recommendation 113, subparagraph *(b)*). As concomitants of this right, the secured creditor must allow the grantor to inspect the encumbered asset at all reasonable times and will be liable in damages for any deterioration of the asset beyond that associated with normal use.

54. Because the secured creditor is in possession, it will most often be in the best position to collect monetary and non-monetary proceeds derived from the encumbered asset.

For this reason, it is common for States to enact a non-mandatory rule that both monetary and non-monetary proceeds are to be collected by the secured creditor in possession. Normally, it is the grantor that will be able to get the best price for non-monetary proceeds generated by encumbered assets (for example, milk produced by cows, eggs produced by chickens and wool produced by sheep). Therefore, States usually also provide that, in the rare case where the secured creditor takes possession of livestock, it should turn the non-monetary proceeds over to the grantor for disposition. Where the non-monetary proceeds involve the natural increase of animals, a common non-mandatory rule is that such offspring are automatically encumbered by the security right and held by the creditor under the same terms as the parent.

55. Where the proceeds are monetary, it often makes little sense to oblige the creditor, after collection, to turn these over to the grantor. The usual non-mandatory rule is that the secured creditor may either apply cash proceeds to repayment of the secured obligation, or hold them in a separate account as additional security. This principle operates whether the cash proceeds received are interest, a blended payment of interest and capital, or a share dividend. Some States even give the creditor the choice of selling additional shares received as a dividend (accounting for the proceeds of sale as if they were cash dividends), or to hold these shares (in the manner of the offspring of animals) as additional encumbered assets. However, it is also common for the secured creditor and the grantor to agree in the security agreement that, so long as the grantor is not in default under the security agreement, dividends in the form of cash may be retained by the grantor.

56. There is great diversity in the non-mandatory rules governing the secured creditor's right to dispose of encumbered assets in its possession. Some States provide that the secured creditor may assign the secured obligation and the security right. That is, the creditor may actually transfer possession of the encumbered asset to a person to whom it has assigned the secured obligation. Some States also provide that the secured creditor may create a security right in the encumbered asset as security for its own debt ("re-pledge" the encumbered assets) as long as the grantor's right to obtain the assets upon payment of the secured obligation is not impaired. Often these re-pledge agreements are limited to stocks, bonds and other instruments held in a securities account, but in some States creditors may re-pledge tangible assets such as diamonds, precious metals and works of art. By contrast, many States prohibit the secured creditor in possession from re-pledging the encumbered assets, even if it can do so on terms that do not impair the grantor's right to recover its assets upon performance of the secured obligation.

57. The risk of loss or deterioration of assets normally follows ownership, not possession. Nonetheless, many States provide that, where encumbered assets in the possession of the secured creditor are destroyed or suffer abnormal deterioration, the secured creditor is presumed to be at fault and must make good the loss. Typically, however, the same non-mandatory rule provides that the creditor is not liable if it can show that the loss or deterioration occurred without its fault. Because it will always be in the secured creditor's interest to ensure that the value of the encumbered assets is maintained, many States provide that the creditor has an insurable interest. Should the secured creditor then insure against loss or damage, however caused, it is entitled to add the cost of the insurance to the secured obligation.

58. This last rule is a particular example of a broader principle enacted as a non-mandatory rule in many States and recommended by the *Guide*. Reasonable expenses

incurred by the secured creditor while discharging its custodial obligation to take reasonable care of the encumbered assets are chargeable to the grantor and automatically added to the secured obligation (see recommendation 113, subparagraph (a)). Tax payments, repairer's bills, storage charges and insurance premiums are examples of such reasonable expenses for which the grantor is ultimately liable.

(c) *Non-mandatory rules where the grantor is in possession*

59. An efficient and effective secured transactions regime is typically designed to encourage responsible behaviour by a grantor that remains in possession of the encumbered assets. Avoiding actions that decrease the value of the encumbered assets beyond depreciation by normal usage is consistent with this objective. Hence, most States impose on the grantor in possession the same obligation of care and preservation as that resting upon secured creditors in possession. The grantor's duty to take care of the encumbered assets includes keeping them properly insured and paying taxes promptly. If the secured creditor incurs these expenses, even though the grantor remains in possession, the secured creditor has the right to reimbursement from the grantor and may add these expenses to the secured obligation.

60. In addition to these mandatory rules, however, many States enact non-mandatory rules aimed at maximizing the economic potential of the encumbered assets when the grantor remains in possession. In particular, encouraging the grantor's use and exploitation of encumbered assets is seen as a way to facilitate revenue generation and repayment of the secured obligation. For this reason, States often provide that, unless otherwise agreed, the grantor in possession does not surrender the general prerogatives of ownership (the right to use and enjoy, the right to appropriate natural and civil fruits or revenues and the right to dispose) simply because a security right has been created. This means that, in a normal situation, the grantor is entitled to use, lease, process and commingle the encumbered asset with other assets in a manner that is reasonable and consistent with its nature and purpose and the parties' objectives as set out in the security agreement. In such cases, the secured creditor should have the right to monitor the conditions in which the encumbered asset is kept, used and processed by the grantor in possession and to inspect the asset at all reasonable times (see recommendation 113, subparagraph (c)).

61. If the encumbered assets consist of income-producing assets in the possession of the grantor, to the extent that the creditor's security right extends to the revenues generated by the asset, the grantor's duties may include maintaining adequate records and the reasonable rendering of accounts regarding the disposition and the handling of the proceeds derived from the encumbered assets. Specific obligations of the grantor in the case of intangible assets (for example, rights to payment of funds credited to a bank account and royalties from the licensing of patents, copyrights and trademarks), and particularly the grantor's right to payment in the form of receivables, are discussed in the next section.

62. Many States have a non-mandatory rule that protects natural and civil fruits or revenues (as opposed to proceeds of disposition in the strict sense) from automatic re-encumbering under the security agreement. The policy objective is to provide the grantor with the chance to gain additional financing by excluding these new assets from coverage by the existing security right. Other States set the default rule so as to encumber

automatically natural and civil fruits or revenues under the initial security right. The policy objective here is that the parties would normally expect and intend natural and civil fruits or revenues to be encumbered and that the non-mandatory rule should reflect these normal expectations. In any event, because this is invariably enacted as a non-mandatory rule, if the parties wish the natural and civil fruits or revenues to be included in or excluded from the scope of the security right, they may freely do so either at the time of negotiating the security agreement or at any time thereafter.

63. The *Guide* provides in chapter II on the creation of a security right that a security right extends to all identifiable proceeds (including proceeds of proceeds) generated by the encumbered asset (see recommendation 19). That is, unless otherwise agreed, any assets derived from the encumbered assets in the grantor's possession are automatically subject to the security right, regardless of whether those additional assets are regarded as civil or natural fruits or as proceeds in the strict sense. To the extent that the fruits of the encumbered asset are in kind (for example, increase in animals and share dividends), the grantor may use and exploit them under the same terms and conditions as the original encumbered assets. Where the fruits of the encumbered asset are natural products such as milk, eggs and wool, the grantor may sell them and the security right extends to the proceeds received upon their disposition. Where the fruits are civil fruits (for example, rentals received from the lease of property and interest received upon the loan of money), the security right will extend to them as long as they remain identifiable. Generally, the grantor in possession will collect civil fruits, whether monetary or near monetary (such as shares, share dividends, bonds, deposit certificates and warrants for the purchase of additional shares). Monetary civil fruits will normally be deposited in a bank account, while near-monetary civil fruits will be deposited to an investment account. Where the civil fruits are in the form of shares acquired as dividends, the grantor is normally given the discretion to leave them in the investment account along with the original encumbered assets. Similarly, the grantor is given the discretion to exercise an option to acquire shares and deposit them in the same investment account. Where civil fruits are not in the form of cash, the grantor may usually dispose of them free of the security right, on the assumption that the cash proceeds thereby generated will also constitute encumbered assets.

64. The duty to preserve the encumbered asset normally means that the grantor in possession is liable for loss or deterioration, whether caused by its fault or by fortuitous event. By contrast, a secured creditor in possession is not liable to the grantor for loss or deterioration caused by a fortuitous event. The reason is that, under basic principles of contract law, the owner of an asset bears the risk of loss arising from a fortuitous event.

65. In principle, the grantor is not entitled to dispose of the encumbered asset without the authorization of the secured creditor. If the grantor does so, the buyer will take the assets subject to the security right (see recommendation 79). By way of exception, however, the grantor may dispose of the encumbered asset free of the security right if it is sold in the seller's ordinary course of business and the buyer does not know that the sale violates the rights of the secured creditor under the security agreement (see recommendation 81, subparagraph (a)). Despite this limitation on disposition, because the grantor will normally retain the full use of the encumbered asset, most States enact non-mandatory rules authorizing the grantor to create additional security rights further encumbering already encumbered assets, the natural and civil fruits or revenues they generate and the proceeds of their disposition. The *Guide's* recommendations are consistent with this

approach (see recommendation 76 and, in respect of acquisition financing under a title retention agreement, recommendation 190). Moreover, the grantor's lack of authority to grant additional security rights does not prevent their successful creation, even though doing so may constitute a default under the security agreement (see recommendations 18 and 23-25).

(d) Non-mandatory rules regardless of who is in possession

66. In addition to the rights specifically given to, and obligations specifically imposed on, secured creditors and grantors because of their possession of the encumbered assets, many States also enact non-mandatory rules that speak to both secured creditor-in-possession (possessory) and grantor-in-possession (non-possessory) situations. Two such rules, one focusing on the grantor's obligations and the other on the secured creditor's rights, are common.

67. The first rule is a corollary of the idea that a grantor in possession should maintain the value of the encumbered assets. If it should happen that the value of the encumbered assets were to decrease significantly, even for reasons unrelated to any lack of attention by the party in possession, some States provide that the grantor will have to offer additional security (or additional assets) to make up for unforeseeable decreases in value. Moreover, this rule is often extended to normal deterioration of the value of the encumbered assets due to wear and tear or market conditions, whenever such deterioration reaches a significant percentage of the initial value of the encumbered assets. Typically, however, parties will provide for "top-up provisions" in their agreement and will specify in detail the conditions under which the grantor will be required to offer further assets should the value of the encumbered assets fall precipitously.

68. A second common non-mandatory rule concerns the right of the secured creditor to assign both the secured obligation and the security right that relates to it. Absent agreement to the contrary, a secured creditor may freely assign the secured obligation and the accompanying security right (see, for example, article 10 of the United Nations Assignment Convention and recommendation 25). Some States even provide that the secured creditor may do so even despite contractual limitations on assignment (see article 9, paragraph 1, of the United Nations Assignment Convention and recommendation 24). Where the secured creditor has possession of the encumbered asset (for example, in the case of a negotiable instrument), this implies that it may also transfer possession to the new secured creditor. In both cases, however, absent a specific agreement to the contrary between the grantor and the original secured creditor (the assignor) authorizing such an arrangement, the assignee of the secured obligation cannot acquire greater rights as against the grantor, or assert greater prerogatives in relation to the encumbered asset, than those that could be claimed by the assignor.

B. Asset-specific remarks

69. The mandatory and non-mandatory rules pertaining to the pre-default rights and obligations of parties relate to the manner in which the prerogatives and responsibilities of ownership are allocated between the grantor and the secured creditor. As already noted,

these include, most importantly: (a) the obligation (invariably imposed upon the party in possession of the encumbered asset) to care for, maintain and preserve it; (b) the right to use, transform, mix and manufacture encumbered assets; (c) the right to collect natural and civil fruits or revenues and other proceeds generated by the assets and to appropriate these to one's use; and, in some States, (d) whether the secured creditor has the right to pledge, re-pledge or dispose of encumbered assets, whether free of, or subject to, the security right.

70. These rules generally contemplate situations involving tangible assets. Nonetheless, in chapter I, the *Guide* notes the importance of intangible assets and, in particular, rights to payment as assets that a grantor might encumber. While certain categories of intangible asset are excluded from the *Guide* (for example, securities and payment rights under financing contracts, see recommendation 4, subparagraphs (c) and (d)), many other types of intangible asset are included: notably, contractual and non-contractual receivables, a right to payment of funds credited to a bank account and a right to receive the proceeds under an independent undertaking (see recommendation 2, subparagraph (a)).

71. The creation of a security right in a right to payment necessarily involves parties other than the grantor and the secured creditor, most obviously the debtor of the receivable. Because the encumbered asset is the obligation owed to the grantor by a third person, States have been required to develop detailed rules to regulate the tripartite relationship among the parties and also between them and third parties. These rules address the rights and obligations of the parties to the security agreement and of third parties, whether the right to payment arises under a tangible asset (for example, a negotiable instrument or a negotiable document) or under an intangible asset (for example, a receivable, a right to payment of funds credited to a bank account or a right to receive the proceeds under an independent undertaking). Most of the rules relating to the relationship between the grantor and the secured creditor on the one hand, and the debtor of the receivable ("third-party obligor" under the *Guide*) on the other, are mandatory but some are non-mandatory. The rights and obligations of third-party obligors are discussed in detail in chapter VII.

72. This section focuses on the pre-default rights and obligations as between the assignor (the grantor) and the assignee (the secured creditor). As in the case of tangible assets, most States take the position that the parties themselves should determine their mutual pre-default rights and obligations (see recommendation 110). Hence, the majority of the rules relating to these rights and obligations are non-mandatory. Nonetheless, because of the impact these rules may have on third parties, States often adopt a mixture of mandatory and non-mandatory rules. Articles 11-14 of the United Nations Assignment Convention provide a good example of this practice in the case of assignments of receivables.

1. Representations of the assignor

73. Some of the most important parts of the agreement between the assignor and the assignee relate to the representations that the assignor makes to the assignee. In the normal case, it is presumed that: (a) the assignor has the right to assign the receivable; (b) the receivable has not been previously assigned; and (c) the debtor of the receivable does not have any defences or rights of set-off that can be set up against the assignor. In other words, if the assignor has doubts about any of these matters, it must explicitly mention

them in the agreement or must explicitly state that it makes no representations to the secured creditor about them. At all events, in parallel with the grantor's pre-default obligations in respect of tangible assets, the assignor must take all reasonable steps necessary to preserve its legal right to collect on the receivable. On the other hand, unless the assignor specifically warrants otherwise, it is presumed that the assignor does not warrant the actual ability of the debtor of the receivable to pay. These various obligations are presented in the form of non-mandatory rules in the national law of most States and are recommended as such in the *Guide* (see recommendation 114).

2. *Right to notify the debtor of the receivable*

74. As the value of the assigned receivable ultimately consists of payment made by the debtor of the receivable, and as that debtor is only obliged to pay the assignee if it actually knows of the assignee's rights, it is important to maximize the capacity of the assignee to make the debtor aware of the assignment. For this reason, most States provide that either the assignor or the assignee may notify the debtor and give instructions about how payment is to be made. Nonetheless, in order to prevent conflicting instructions from being given, these States normally also provide that, once notice of the assignment has been given, only the assignee may direct the debtor as to the manner and place of payment. The *Guide* also adopts this well-established framework for notifying the debtor of the receivable (see recommendation 115).

75. There may, of course, be situations where the assignor and the assignee (or just one of them) do not wish the debtor of the receivable to know of the assignment. This desire may relate to particular features of the assignor's business or to general economic conditions. For this reason, States usually provide that the assignor and assignee may agree to postpone notifying the debtor of the receivable that the assignment has occurred until some later time. Until such notice is given, the debtor of the receivable will continue to pay the assignor according to the original agreement between them or any subsequent payment instructions. Where a party (usually the assignee) is in breach of an obligation not to notify, this should not prejudice the debtor of the receivable. The debtor of the receivable will thereafter be required to pay according to the instructions given and is entitled to receive a discharge for amounts so paid (see recommendation 119). Nonetheless, many States also provide that, unless the assignor and assignee otherwise agree, such a breach of the obligation not to give notice may give rise to liability for any resulting damages. The *Guide* recommends that these general principles govern notification of the assignment to the debtor of the receivable (see recommendation 115).

3. *Right to payment of the receivable*

76. Because the right to payment is the actual reason for taking the security, it is important to specify the effect of any payment made by the debtor of the receivable (whether to the assignor or the assignee) on the respective rights of assignor and assignee. Many States have enacted non-mandatory rules to govern payments made in good faith that may not actually be made according to the intention of the assignor or assignee. This can sometimes occur because the debtor of the receivable has received conflicting payment instructions or learns of the assignment without actually having received formal notice of it.

77. There are two standard situations that these rules typically address. First, even if no notification of the assignment is given to the debtor of the receivable, payment might actually be made to, or received by, the assignee. Given the purpose of the security right in the receivable, it is more efficient that the assignee be entitled to keep the payment, applying it to a reduction of the assignor's obligation. Similarly, if payment is made to the assignor after the assignment has been made, and again regardless of whether the debtor of the receivable has received notice, the assignor should be required to remit the payment received to the assignee. Likewise, once notice has been given, if part of the payment obligation is to return certain tangible assets to the assignor, States often provide that these assets should be handed over to the assignee. For example, if part of the payment obligation of the debtor of the receivable is to transfer a negotiable instrument to the assignor, once notice is received, the negotiable instrument should be transferred to the assignee. Adoption of this set of practices to govern misdirected payments is recommended in the *Guide* (see recommendation 116, subparagraph (a)). In all these cases, of course, the rules adopted by many States are non-mandatory and, as a result, the assignor and assignee may provide for a different outcome in their agreement.

78. In the case of multiple assignments of a receivable, the debtor of the receivable may receive multiple notifications and may be uncertain as to which assignee has priority. Sometimes, the payment is made in good faith to an assignee that has a lower priority. In such cases, States usually provide that the assignee with a higher-ranking priority should not be deprived of its rights to obtain payment and, where the payment obligation involves the return of assets to the assignor, its right to receive these assets as well. The assignee with a lower-ranking priority must remit the payment and return the assets to the assignee with a higher-ranking priority. Consistent with its general approach to allocating pre-default rights and obligations as between the assignor and the assignee, the *Guide* recommends that these general principles govern cases where payment has been made to a person not actually entitled to receive it (see recommendation 116, subparagraph (a)).

79. Whatever the circumstances under which the assignee obtains payment, States invariably provide, by means of a mandatory rule, that the assignee may only retain the payment to the extent of its rights in the receivable. In other words, if the payment made by the debtor of the receivable is greater than the outstanding indebtedness of the assignor, the assignee may not keep the surplus (see recommendation 152). The assignee must remit the excess to the person that is entitled to it (the next lower-ranking assignee or the assignor, as the case may be). In the same manner that a secured creditor that has been fully satisfied must either remit tangible assets to the grantor or ensure that notice of its rights is expunged from the general security rights register, some States also require an assignee that has been fully satisfied to notify the debtor of the receivable of that fact, and that it should no longer receive payment. Although the *Guide* does not recommend that assignees be required to send such a notice to the debtor of the receivable, because assignees may not retain more than the value of their right in the receivables (see recommendation 116, subparagraph (b)), assignees may, as a practical matter, either send such a notice or join with the assignor in sending such a notice.

80. These mandatory and non-mandatory rules relating to pre-default rights and obligations of assignors and assignees of intangible assets help to structure the relationship between them. In many ways, these non-mandatory rules reflect what non-mandatory rules are meant to accomplish, which is why they are explicitly stated in the national law

of many States and why they are found in articles 12-14 of the United Nations Assignment Convention. For this reason also, the *Guide* recommends that they be included in any law relating to secured transactions in order to facilitate the efficient assignment and collection of receivables, while nonetheless permitting assignors and assignees to structure their own transactions differently so as to meet their own needs and wishes.

C. Recommendations 110-116

Purpose

The purpose of provisions on the rights and obligations of the parties is to enhance efficiency of secured transactions and reduce transaction costs and potential disputes by:

- (a) Providing mandatory rules relating to the rights and obligations of the party in possession of the encumbered asset;
- (b) Providing non-mandatory rules relating to the rights and obligations of the parties that apply in cases where the parties have not addressed these matters in their agreement; and
- (c) Providing non-mandatory rules to serve as a drafting aid or checklist of issues the parties may wish to address in their agreement.

1. General recommendations

*Rights and obligations of the parties to a security agreement*⁴

110. The law should provide that the mutual rights and obligations of the parties to a security agreement are determined by:

- (a) The terms and conditions set forth in that agreement, including any rules or general conditions referred to therein;
- (b) Any usage to which they have agreed; and
- (c) Unless otherwise agreed, any practices they have established between themselves.

Mandatory rules

111. The law should provide that the party in possession of an encumbered asset must take reasonable steps to preserve the asset and its value.

112. The secured creditor must return an encumbered asset in its possession if, all commitments to extend credit having been terminated, the security right has been extinguished by full payment or otherwise.⁵

Non-mandatory rules

113. The law should provide that, unless otherwise agreed, the secured creditor is entitled:

- (a) To be reimbursed for reasonable expenses incurred for the preservation of an encumbered asset in its possession;
- (b) To make reasonable use of an encumbered asset in its possession and to apply the revenues it generates to the payment of the secured obligation; and
- (c) To inspect an encumbered asset in the possession of the grantor.

⁴For recommendation 110, see article 11 of the United Nations Assignment Convention.

⁵For the secured creditor's duty to cancel a registered notice, see recommendation 72, chapter IV on the registry system.

2. Asset-specific recommendations

*Representations of the assignor*⁶

114. With respect to an assignment of a contractual receivable, the law should provide that:

(a) Unless otherwise agreed between the assignor and the assignee, the assignor represents at the time of conclusion of the contract of assignment that:

- (i) The assignor has the right to assign the receivable;
- (ii) The assignor has not previously assigned the receivable to another assignee; and
- (iii) The debtor of the receivable does not and will not have any defences or rights of set-off; and

(b) Unless otherwise agreed between the assignor and the assignee, the assignor does not represent that the debtor of the receivable has, or will have, the ability to pay.

Right to notify the debtor of the receivable

115. The law should provide that:

(a) Unless otherwise agreed between the assignor and the assignee, the assignor or the assignee or both may send the debtor of the receivable notification of the assignment and a payment instruction, but after notification has been sent only the assignee may send such an instruction; and

(b) Notification of the assignment or a payment instruction sent in breach of any agreement referred to in subparagraph (a) of this recommendation is not ineffective for the purposes of recommendation 120 (chapter VII on the rights and obligations of third-party obligors) by reason of such breach. However, nothing in this recommendation affects any obligation or liability of the party in breach of such an agreement for any damages arising as a result of the breach.

Right to payment

116. The law should provide that:

(a) As between the assignor and the assignee, unless otherwise agreed and whether or not notification of the assignment has been sent:

(i) If payment in respect of the assigned receivable is made to the assignee, the assignee is entitled to retain the proceeds and tangible assets returned in respect of the assigned receivable;

(ii) If payment in respect of the assigned receivable is made to the assignor, the assignee is entitled to payment of the proceeds and also to tangible assets returned to the assignor in respect of the assigned receivable; and

(iii) If payment in respect of the assigned receivable is made to another person over whom the assignee has priority, the assignee is entitled to payment of the proceeds and also to tangible assets returned to such person in respect of the assigned receivable;

(b) The assignee may not retain more than the value of its right in the receivable.

⁶For recommendations 114-116, see articles 12-14 of the United Nations Assignment Convention.

VII. Rights and obligations of third-party obligors

A. General remarks

1. Introduction

1. Intangible assets play an increasingly important role in modern secured transactions regimes. The *Guide* recognizes this fact in several chapters (see, for example, chapter I on the scope of application, basic approaches to secured transactions and general themes common to all chapters of the *Guide*, paras. 5-9 and 78-84), and devotes significant attention to intangible assets in numerous recommendations (see recommendations 23-27 on the creation of a security right, recommendations 48-50 on the third-party effectiveness of a security right, recommendations 103-107 on the priority of a security right, recommendations 114-117 on the rights and obligations of the parties to a security agreement and recommendations 167-176 on the enforcement of a security right). While certain categories of intangible asset may be excluded from the *Guide*, many other types of intangible asset and, in particular, rights to payment, are included (see recommendation 2, subparagraph (a)).

2. When the encumbered asset in a secured transaction consists of a right against a third party, the secured transaction is necessarily more complicated than when the encumbered asset is a simple asset such as a piece of equipment. Such rights against third parties may include “receivables”, rights embodied in “negotiable instruments”, rights embodied in “negotiable documents”, “rights to receive the proceeds under an independent undertaking” and “rights to payment of funds credited to a bank account”. While these rights against third parties differ from each other in important ways, they have a critical feature in common: the value of the encumbered asset is the right to receive performance from a third party that owes an obligation to the grantor. The *Guide* refers to such a third party as a “third-party obligor”.

3. There can also be rights against third parties that do not fall into one of the five categories enumerated above. The *Guide* is intended to cover these other rights as well when they serve as encumbered assets. Thus, while the *Guide* provides specific recommendations only for each of the five enumerated categories, the same general principles discussed in this chapter also apply to these other rights, except to the extent that their nature requires a different rule that might be found in another body of law that specifically addresses such rights.

4. Depending on the nature of the right against a third party that constitutes an encumbered asset, the *Guide* uses varying terminology to describe the third-party obligor. When the right is a receivable, for example, the third-party obligor is referred to as the “debtor of the receivable”, and when the obligation is the right to proceeds under an independent undertaking, the third-party obligor is referred to as the “guarantor/issuer, confirmer or other nominated person”.

5. In all cases where the encumbered asset is a right against a third-party obligor, the secured transaction affects not only the grantor and the secured creditor but may also affect the third-party obligor. Accordingly, States typically provide protection against adverse effects on the third-party obligor, since that obligor is not a party to the secured transaction. Of course, States must also ensure that such protection does not unduly burden the creation of security rights in rights against third-party obligors, since these security rights facilitate the extension of credit by the secured creditor to the grantor, which may often redound to the economic benefit of the third-party obligor.

6. The detailed rules governing the mutual rights and obligations of grantors and secured creditors where the encumbered asset is a right to payment have already been discussed (see chapter VI on the rights and obligations of the parties, paras. 69-80). The present chapter focuses instead on the rights and obligations of third-party obligors. It first reviews, in section A.2 (a), a number of general issues. It then addresses, in sections A.2 (b)-2 (f), the rights and obligations of third-party obligors in the different contexts where they most frequently arise. The chapter concludes, in section B, with a series of recommendations.

2. *Effect of a security right on the obligations of a third-party obligor*

(a) *General*

7. States generally recognize that it would be inappropriate for a security right in a right to performance from a third-party obligor to change the nature or magnitude of the third-party obligor's obligation towards its creditor. This basic principle is also present in international instruments. For example, article 15 of the United Nations Assignment Convention permits no change in the payment obligation, other than the identity of the person to which payment is owed (and, with some limitations, the address or account to which payment is to be made; see para. 12 below). The principle is general and applies equally to all obligations regardless of how the obligation arises or the manner in which it is expressed. The foregoing holds even though the recommendations of the *Guide* address only situations where the relevant obligation is an obligation to make payment under a negotiable instrument, an obligation to make payment of funds credited to a bank account, an obligation to make payment of the proceeds under an independent undertaking, an obligation to deliver the relevant goods under a negotiable document or an obligation to make payment under a contract.

8. When a negotiable instrument or negotiable document evidences a right against a third-party obligor, this principle is already reflected in law that is well developed in most States and that addresses in detail the effect of an assignment of the negotiable instrument or negotiable document or the obligation of the obligor hereunder. This body of law is generally referred to in the *Guide* as the law governing negotiable instruments or the law governing negotiable documents (see Introduction, section B, Terminology and interpretation, para. 19). There is no need for secured transactions law to recreate those rules. Accordingly, the *Guide* generally defers to those bodies of law for effectuation of this principle. Similar provisions exist in respect of the rights of a bank in relation to funds credited to a bank account, and of the rights of a guarantor/issuer, confirmer or nominated person or any other beneficiary named in an independent undertaking or to which a transfer of the right to draw has been effected; in all such cases, the *Guide* likewise takes a deferential position.

(b) *Effect of a security right on the obligations of the debtor of a receivable*

9. While the effect of a security right on the obligor of a negotiable instrument or negotiable document is well developed in most States, this is not always the case with respect to a receivable that is the subject of a security right. Accordingly, the *Guide* addresses in some detail the effect of a security right on the obligation of the debtor of the receivable. For the most part, the *Guide* draws its policies and recommendations (often verbatim) from the analogous rules in the United Nations Assignment Convention.

10. In many States, it is not possible to grant a security right in a receivable. The only mechanism by which the creditor of a receivable may use the receivable as an asset to secure a loan is to assign the receivable to another creditor. Moreover, in some States, it is not possible to assign a receivable by way of security. That is, in those States, it is not possible to make the assignee's right to collect the receivable contingent upon the assignor itself continuing to owe an obligation to the assignee. Only outright assignments of receivables are possible. However, regardless of whether the transaction is an outright assignment, an assignment by way of security or a transaction that creates a security right, the legal mechanisms that establish the mutual rights and obligations of the parties and their rights as against third-party obligors are similar. For this reason, and because it is sometimes difficult to determine exactly the nature of the underlying transaction between the assignor and the assignee, many States treat all forms of transfer of receivables broadly in the same manner. This is also the approach taken by the United Nations Assignment Convention.

11. Consistent with that approach, the *Guide* covers not only security rights in receivables but also outright transfers and transfers by way of security (see recommendation 3). Therefore, the discussion in this chapter also covers the rights and obligations of the debtor of the receivable in transactions in which the receivable has been transferred outright or utilized as an encumbered asset, whether in an assignment by way of security or by granting a security right in the receivable. Moreover, the term "assignment" is used in this chapter to refer to all three types of transaction, except where otherwise indicated. It is important to signal, however, that treating these transactions under a common set of rules does not result in converting an outright transfer of a receivable to a secured transaction (see chapter I on the scope of application, para. 31).

(i) *Protection of the debtor of the receivable*

12. The United Nations Assignment Convention provides that, with few exceptions, the assignment of a receivable does not affect the rights and obligations of the debtor of the receivable without its consent. A similar principle is found in the national law of many States. The *Guide* recommends this approach as well (see recommendation 117, paragraph (a)). The only effect that the assignment may have on the debtor of the receivable is to change the person, address or bank account to which the debtor of the receivable is to make payment. However, so as not to impose hardship on the debtor of the receivable, the Convention provides that such changes of the person, address or payment account may not result in changing the currency of payment or the State in which payment is to be made, unless the change is to the currency of the State in which the debtor of the receivable is located (see article 15 of the Convention). This is the approach recommended in the *Guide* (see chapter I on the scope of the *Guide*, paras. 30-31 and recommendation 117, subparagraph (b)).

13. When the assignment of a receivable is an outright transfer, the ownership of the right to receive performance from the debtor of the receivable also changes. While some States characterize this type of transaction as involving a change of ownership, others simply provide that the payment right reflected by the receivable has been transferred to the patrimony of the assignee. However the transaction is characterized, it does not necessarily mean that the party to which payment is to be made will also change. This is because, in many cases, the assignee will enter into an arrangement with the assignor under which the latter will continue to collect the receivable on behalf of the assignee.

14. Even when the assignment of a receivable is by way of security, the transaction is sometimes structured as an immediate transfer of the receivable to the assignee. In these cases, the assignor normally also collects the receivable on behalf of the assignee but, until default, need not remit more than is necessary under the agreement between them. Sometimes, by contrast, the assignment is conditional, and the assignee acquires no rights in the receivable until the occurrence of a default by the assignor. Until that time, the third-party obligor continues to pay the assignor under the terms of the original contract between them and may not even know of the assignment.

15. The same practical result typically occurs when the assignment of a receivable involves the creation of a security right. The assignment does not necessarily mean that the party to which payment is to be made will change. In many cases, the arrangement between the assignor and the assignee will be that payments are to be made to the assignor until a default by the assignor. Only upon default will the assignee seek to receive payment directly from the debtor of the receivable. In other cases, the parties will agree that payments are to be made to the assignee. Under this type of arrangement, the assignee normally holds the money received in a separate account and withdraws from that account only an amount necessary to fulfil the assignor's payment obligation. The balance is held for the assignor, and remitted once the credit has been fully paid.

16. In all the above-mentioned cases, the mechanism by which the assignee acquires rights to collect the receivable directly from the debtor of the receivable is through the giving of a notice. The general practice is that the notice must actually be received by the debtor of the receivable and must be in a language that can reasonably be expected to inform that debtor of the receivable about its contents. As the point of the notice is to change the instructions relating to payment, it may only affect future payments due on existing receivables or receivables arising after the notification (see article 16 of the United Nations Assignment Convention and recommendation 118).

(ii) Discharge of the debtor of the receivable by payment

17. In view of the fact that the obligation of the debtor of the receivable normally will be discharged only to the extent of payment to the party entitled to payment under the law and may not be discharged if mistakenly made to a different party, the debtor of the receivable has an obvious interest in knowing the identity of the party to which payment is to be made. As just noted, the proper payee may not necessarily be the "owner" of the receivable. Thus, many States protect the debtor of the receivable by providing that the debtor of the receivable is discharged by paying in accordance with the original contract until such time as it receives notification of the assignment and of any change in the person or address to which

payment should be made. This principle provides important protection to the debtor of the receivable since it avoids the possibility that a good-faith payment will be found not to discharge the debtor of the receivable because the payment was made to a party that was no longer entitled to receive it (see article 17, paragraph 1, of the United Nations Assignment Convention and recommendation 119, subparagraph (a)).

18. Once the debtor of the receivable has been notified of the assignment and any new payment instructions, however, it is appropriate to require the debtor of the receivable to pay in accordance with such instructions. This principle is critical to the economic viability of secured transactions where the encumbered asset being relied upon by the secured creditor is a receivable. If the debtor of the receivable were to continue to be able to pay the assignor, this would deprive the assignee of the value of the assignment. Every payment made by the debtor of the receivable reduces the outstanding balance of the receivable and, consequently, the value of the receivable as an encumbered asset. For the assignee, being able to obtain payment directly from the debtor of the receivable once instructions have been given is especially important when the assignor is in financial distress (see article 17, paragraph 2, of the United Nations Assignment Convention and recommendation 119, subparagraph (b)).

19. States that permit the assignment of receivables typically impose no limitations on the number of assignments or sub-assignments that can be made. For example, an assignor may assign a receivable by way of security to secured creditor A, and later create a second security right in that receivable in favour of secured creditor B, and still later create a third security right in that receivable in favour of secured creditor C. Of course, should the first assignment be an outright assignment made effective against third parties, no further assignments by the assignor (whether outright or as security) are possible. In addition, the assignee of a receivable, whether in an outright transfer or in an assignment by way of security, may also assign its rights as assignee. So, for example, in the situation just presented, secured creditor A may assign its rights to another secured creditor as security for its own obligations, or it may transfer its rights absolutely to a third party. Similarly, secured creditor B may assign its rights to a third party, which may then further assign those rights to another third party. It is thus obvious that it may sometimes be difficult for the debtor of the receivable to know exactly to which party payment is to be made.

20. To protect the debtor in such cases, States that permit multiple assignments usually specify in detail a number of principles to determine the assignee to which the debtor has to make payment in order to be discharged. The basic ideas are three: (a) where there are multiple notifications with payment instructions from the same assignee relating to a single assignment of the same receivable by the same assignor, the last notification with payment instructions received prior to the payment prevails; (b) where there are multiple notifications with payment instructions from multiple assignees relating to more than one assignment of the same receivable by the same assignor, the first notification prevails; and (c) where there are multiple notifications with payment instructions from multiple subsequent assignees of the same receivable, the last notification prevails. In addition to these three principles, States also elaborate rules to govern the assignment of undivided interests in receivables, as well as rules setting out the right of the debtor of the receivable to require adequate proof of the assignment. These generally accepted principles are embodied in article 17 of the United Nations Assignment Convention and are also reflected in the recommendations of the *Guide* (see recommendation 119, subparagraphs (c)-(h)).

(iii) *Defences and rights of set-off of the debtor of the receivable*

21. As noted above, it would be inappropriate for an assignment of a receivable to change the nature or magnitude of the obligation of the debtor of the receivable. One implication of that principle is that the assignment should not, without the consent of the debtor of the receivable, deprive it of defences arising out of the original contract or rights of set-off arising prior to the receipt of notification of an assignment (see article 18 of the United Nations Assignment Convention and recommendation 120).

22. This principle should not, however, prevent the debtor of the receivable from agreeing with the assignor that it may not raise against an assignee defences or rights of set-off that it could otherwise raise against the assignor. The effect of such an agreement is to confer on the receivable the same sort of negotiability that enables negotiable instruments to be enforced by protected holders without regard to defences or rights of set-off (for the meaning of the term “protected holder”, see, for example, article 29 of the United Nations Convention on International Bills of Exchange and International Promissory Notes¹ (hereinafter referred to as the “United Nations Bills and Notes Convention”). As the receivable could have been embodied in a negotiable promissory note or similar negotiable instrument with the agreement of the debtor of the receivable, there is no reason to prevent the debtor of the receivable from agreeing to the same result as would have been achieved by the use of a negotiable promissory note or similar negotiable instrument (see recommendation 121, subparagraph (a)). However, under the laws of most States, as in the United Nations Bills and Notes Convention, there are certain defences that can be raised even against a protected holder (see, for example, paragraph 1 of article 30 of the United Nations Bills and Notes Convention). In principle, the same result should follow when the debtor of a receivable agrees not to raise defences against the assignee of a receivable (see article 19, paragraph 2, of the United Nations Assignment Convention and recommendation 121, subparagraph (b)).

(iv) *Modification of the original contract*

23. When a receivable is created by contract, it is always possible that the debtor of the receivable and its original creditor might modify the terms of the obligation at a later time. If such a receivable is assigned, the effect of that modification on the rights of the assignee must be determined. In cases where the modification occurs before the assignment, the right actually assigned to the assignee is the original receivable as so modified. Most States also take the position that a debtor of the receivable is not affected by an assignment of which it has no knowledge. Thus, for example, if the modification occurs after the assignment, but before the debtor of the receivable has become aware that the original creditor has assigned the receivable, it is understandable that the debtor of the receivable would believe that the agreement of modification was entered into with the original creditor of the receivable and, thus, would be effective. Accordingly, States generally provide that such a modification is effective as against the assignee (see, for example, article 20, paragraph 1, of the United Nations Assignment Convention and recommendation 122, subparagraph (a)).

¹United Nations Publication, Sales No. E.95.V.16.

24. Where, by contrast, the agreement to modify the terms of the receivable is entered into after the assignment has already occurred and after the debtor has been notified of it, such a modification is usually not effective unless the assignee consents to it. The reason is that, at this point, the assignee's right in the receivable has already been established and such a modification would change the assignee's rights without its consent. Some States, however, provide limited exceptions to this rule. For example, if the right to be paid has not yet been fully earned by performance by the original creditor of the receivable (the assignor), and the original contract provides for the possibility of its modification, the modification may be effective against the assignee. In certain cases, the original contract need not even expressly provide for modification. The usual example would be where the original contract governs a long-term relationship between the debtor and the creditor of the receivable, and the relationship is of the sort that is frequently the subject of modification. In this situation, the assignee might anticipate that reasonable modifications might be made in the ordinary course of business even after the assignment. As a result, some States provide that a modification to which a reasonable assignee would consent is effective against the assignee, even if made after the debtor of the receivable became aware of the assignment, so long as the receivable has not yet been fully earned by performance (see article 20, paragraph 2, of the United Nations Assignment Convention and recommendation 122, subparagraph (b)).

(v) *Recovery of payments already made*

25. As a general rule, the assignor's right to receive payment from the debtor of the receivable arises because the assignor has performed the obligation for which payment is to be made (for example, the sale of a vehicle, the performance of a service). Sometimes the debtor of the receivable may pay part of the price in advance of the asset being delivered or the service being rendered. This payment may well end up in the hands of the assignee, either because the assignor has remitted it to the assignee or because the assignee has given notice to the debtor of the receivable and has obtained payment directly. Normally, contract law provides that, if one party does not perform, the other party may have the contract annulled or seek damages for the breach. However, once the payment has passed into the hands of the assignee, many States provide that the only recourse of the debtor of the receivable is against the assignor and that sums received by the assignee cannot be recovered.

26. The policy behind this rule flows from the general law of obligations. Absent fraud, creditors of a party in default under a contract are not permitted to reclaim money that may have been paid in good faith to other creditors. Hence, if payment is made to the assignor, which then transfers the funds paid to the assignee, the assignee stands in the same position as any other creditor that has been paid by the assignor. This should also be the case where the assignor fulfils its own obligation towards the assignee by having the debtor of the receivable make payment directly to the assignee. In both situations, normal principles governing the law of obligations apply, and the assignee should not be required to return the payment received to the debtor of the receivable simply because the assignor has not performed its correlative obligation. In essence, this means that the debtor of the receivable bears the insolvency risk of its contractual partner. The *Guide* recommends this general principle (see article 21 of the United Nations Assignment Convention and recommendation 123).

(c) *Effect of a security right on the obligations of an obligor under a negotiable instrument*

27. In most States, the law governing negotiable instruments is well developed and contains clear rules as to the effect of a transfer of an instrument on the obligations of parties to the instrument. In principle, those rules continue to apply in the context of security rights in negotiable instruments (see recommendation 124).

28. Thus, for example, a secured creditor with a security right in a negotiable instrument is not able to collect on the instrument except in accordance with its terms. Even if the grantor has defaulted on its obligation under the security agreement, the secured creditor cannot enforce the negotiable instrument against an obligor except when payment is due under that instrument. For example, if a negotiable instrument is payable only at maturity, a secured creditor is not permitted to require payment prior to maturity (even if the grantor of the security right, as opposed to the obligor under the instrument, is in default), except in accordance with the terms of the negotiable instrument itself.

29. In addition, unless otherwise agreed by the obligor, the secured creditor cannot collect on the negotiable instrument except in accordance with the law governing negotiable instruments. Typically, as a matter of the law governing negotiable instruments, the secured creditor may only collect on the negotiable instrument if it is a holder (that is, is in possession of the instrument and has obtained any necessary endorsement) or has acquired the rights of a holder. Accordingly, in order to be assured of obtaining a discharge, the obligor is often permitted to insist, under the law governing negotiable instruments, on paying only the holder of the instrument. Notwithstanding this general principle, in some States, if a holder of an instrument transfers the instrument to a person that is merely a transferee but not a holder, the transferee can enforce the instrument if it has actual physical possession of the instrument.

30. Under the law governing negotiable instruments, the secured creditor may or may not be subject to the claims and defences of an obligor on the instrument. If the secured creditor is a protected holder of the negotiable instrument, the secured creditor is entitled to enforce the negotiable instrument free of certain claims and defences of the obligor. These claims and defences are the so-called “personal” claims and defences, such as normal contract claims and defences, which the obligor could have asserted against the prior holder. However, under the law governing negotiable instruments, even if the secured creditor is a protected purchaser, it remains subject to so-called “real” defences of the obligor, such as lack of legal capacity, fraud in the inducement or discharge in insolvency proceedings.

31. If the secured creditor is a holder of the negotiable instrument but not a protected holder, it is nonetheless entitled to collect on the negotiable instrument, but usually will be subject to the claims and defences that the obligor could have asserted against a prior holder of the negotiable instrument. These claims and defences include all personal claims and defences unless the party liable under the negotiable instrument has effectively waived its right to assert such claims and defences in the negotiable instrument itself or by separate agreement.

(d) *Effect of a security right on the obligations of the depositary bank*

32. In States in which a security right in a right to payment of funds credited to a bank account may be created only with the consent of the depositary bank, the bank has no duty to give its consent. In these States, the result is that, even as between the secured creditor and the grantor, a security right may not be created in a right to payment of funds credited to the bank account without the agreement of the bank. By contrast, other States do not require the consent of the depositary bank for the creation of the security right. Nonetheless, even in these States the rights and obligations of the depositary bank itself may not be affected without its consent. Because the *Guide* generally distinguishes between the effectiveness of a security right between the parties, on the one hand, and the effectiveness of a security right against third parties, on the other hand, the second of the two aforementioned approaches is adopted by the *Guide* (see recommendation 125, paragraph (a)). In both cases, however, the main reason for protecting the bank in the absence of its explicit consent lies in the critical role of banks in the payment system and the need to avoid interfering with banking law and practice.

33. The policy rationale for protecting banks in this manner is that imposing duties on a depositary bank or changing the rights and duties of a depositary bank without its consent may subject the bank to risks that it is not in a position to manage appropriately unless it knows in advance what those risks might be. Banking is subject to significant operational risks, with funds being debited or credited to bank accounts daily, often with credits being made on a provisional basis, and sometimes involving other transactions with the depositary bank's customers. These risks are compounded by the legal risk to the depositary bank of failing to comply with laws dealing with negotiable instruments, credit transfers and other payment system rules in its day-to-day operations. The bank is also exposed to the further risk of not complying with certain duties imposed on the depositary bank by other law, such as laws requiring it to maintain the confidentiality of its dealings with its customers. In addition, the depositary bank is typically subject to regulatory risk under laws and regulations of the State designed to ensure the safety and soundness of depositary banks. Finally, the depositary bank is subject to reputational risk in choosing the customers with which it agrees to enter into transactions.

34. The experience in those States where the depositary bank's consent to new or changed duties is required suggests that the parties are often able to negotiate satisfactory arrangements so that the depositary bank is comfortable that it is managing the risks involved, given the nature of the transaction and the business of its customer. The policy rationale for protecting the general operations of the banking system involves a further principle that bears on the effect of a security right in a bank account on the rights of the depositary bank. To avoid any interference with the depositary bank's rights of set-off against the account holder, legal systems that permit the depositary bank to obtain a security right in the right to payment of funds credited to a bank account held with the bank provide that the bank retains any rights of set-off it might have under law other than the secured transactions law (see recommendation 125, subparagraph (b)).

35. The same policy rationale applies with respect to principles governing the third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account. For example, in States that prescribe "control" as the method for achieving third-party effectiveness of a security right in a right to payment of

funds credited to a bank account (see recommendation 49), the law typically provides that the bank is not obligated to enter into a control agreement with a secured creditor (see recommendation 126, paragraph (c)). The law also usually provides that the bank is not obligated to pay any secured creditor other than a secured creditor that has control with respect to the funds credited to the account (see recommendation 126, subparagraph (a)). In these States, moreover, there are appropriate rules to safeguard the confidentiality of the relationship of a bank and its client, such as the rule that the bank has no obligation to respond to requests for information about whether a control agreement exists or whether the account holder retains the right to dispose of funds credited to its bank account (see recommendation 126, subparagraph (b)).

36. In States in which the security right in a right to payment of funds credited to a bank account can be made effective against third parties by registration of a notice in a public registry or by acknowledgement on the part of the depositary bank, the notice or acknowledgement may or may not impose duties on the depositary bank to follow instructions from the secured creditor as to the funds in the account. If such duties are not imposed on the depositary bank under the laws of a particular State, the secured creditor's right to obtain the funds in the bank account upon enforcement of the security right would usually depend upon whether the customer-grantor has instructed the depositary bank to follow the secured creditor's instructions as to the funds or the depositary bank has agreed with the secured creditor to do so. In the absence of such instructions or agreement, the secured creditor may need to enforce the security right in the bank account by using judicial process to obtain a court order requiring the depositary bank to turn over the funds credited to the bank account to the secured creditor.

37. In States in which the depositary bank is permitted to subordinate its priority position, the bank has no duty to subordinate its rights to a security right being asserted by another creditor of the account holder. Even if, in order to facilitate the creation, third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account, the secured creditor is willing to become the depositary bank's customer with respect to the bank account, the depositary bank has no duty to accept the secured creditor as its customer. This result is consistent with the general position taken in the *Guide* that any mechanisms by which secured transactions law aims to facilitate the granting of security over funds credited to a bank account should not impair national regulatory laws or other laws designed to assure the safety and soundness of the banking system.

(e) *Effect of a security right on the obligations of the guarantor/issuer, confirmer or nominated person under an independent undertaking*

38. The rights and duties of the guarantor/issuer, confirmer or nominated person with respect to an independent undertaking are quite well developed under the law and practice governing independent undertakings. This highly specialized law and practice has facilitated the usefulness of independent undertakings, particularly in international trade. Accordingly, when developing a secured transactions law with respect to independent undertakings, States normally take great care to avoid interfering with these commercial mechanisms. Moreover, in order to ensure that this law and practice continues to function effectively in international trade, States typically adopt the specialized

vocabulary by which the various parties to an independent undertaking are currently identified (for examples of this approach, see the United Nations Guarantee and Stand-by Convention, the Uniform Customs and Practice for Documentary Credits, the Rules on International Standby Practices and the Uniform Rules for Demand Guarantees and recommendations 27, 48, 50, 107 and 176).

39. In considering how to elaborate an appropriate secured transactions regime for such cases, it is helpful to distinguish between the independent undertaking itself and the right to draw, on the one hand, and the right of a beneficiary of such an undertaking to receive a payment or another item of value due from the guarantor/issuer or nominated person, on the other hand. Providing for a security right in the right to draw without interfering with the usefulness of the independent undertaking is a delicate task and usually can only be done by an agreed-upon transfer of the undertaking itself. By contrast, creating a security right in the right of the beneficiary to receive payment carries fewer risks because it relates only to the right of the beneficiary to receive whatever may become due. That is, it would not have an effect on the rights and obligations of the guarantor/issuer, confirmer or nominated person. For this reason, the *Guide* recommends rules facilitating the use of the beneficiary's right to receive the proceeds under an independent undertaking as an encumbered asset, but with strict conditions designed to avoid compromising the usefulness of independent undertakings. A first condition relates to how the encumbered asset is described. The "right to receive the proceeds under an independent undertaking" refers to the beneficiary's right to receive the proceeds as contrasted with the cash and other assets that actually constitute the proceeds of the independent undertaking (and as contrasted with "the right to draw"). The security right does not, that is, encumber the specific proceeds themselves, as that term is commonly used in independent undertaking practice. The basic principles that should govern the interaction of the law relating to independent undertakings and secured transactions law, as reflected in the recommendations of the *Guide*, are described below.

40. A cardinal principle is that a secured creditor's rights in the right to receive the proceeds under an independent undertaking should be subject to the rights, under the law and practice governing independent undertakings, of the guarantor/issuer, confirmer or nominated person. Thus, a secured creditor may not assert a right to payment of the proceeds otherwise not payable to the secured creditor's grantor (see recommendation 127, subparagraph (a)). For the same reason, a transferee-beneficiary normally takes the undertaking, including both the right to draw and the right to receive payment of the proceeds, without being affected by a security right in the right to receive proceeds under the independent undertaking created by the transferor (see recommendation 127, subparagraph (b)). For the same reason, if the guarantor/issuer, confirmer or nominated person also has a security right in the right to receive the proceeds under an independent undertaking, their independent rights arising from the independent undertaking are not adversely affected simply because they also have a security right in the right to receive the proceeds (see recommendation 127, subparagraph (c)).

41. Equally important is the principle that a guarantor/issuer, confirmer or nominated person should not be obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the proceeds under an independent undertaking (see recommendation 128). The reason for this rule is that the usefulness of independent

undertakings as a low-cost and efficient method for facilitating the flow of commerce would be compromised if the guarantor/issuer, confirmer or nominated person had to verify the background transaction by which the right was purportedly transferred and to which it had not consented.

42. By contrast, if a secured creditor has made its security right effective against third parties by control (see recommendation 50), it may enforce its rights against the guarantor/issuer, confirmer or nominated person. In this context, however, control has a very particular meaning. Control means that the secured creditor is expressly acknowledged by the guarantor/issuer, confirmer or nominated person as an assignee of the proceeds under an independent undertaking (see recommendation 129).

(f) Effect of a security right on the obligations of the issuer or other obligor under a negotiable document

43. In most States, the law governing negotiable documents is well developed and contains clear rules as to the effect of a transfer of a document on the obligations of parties to the document. In principle, those rules continue to apply in the context of security rights in negotiable documents. This is the approach recommended by the *Guide* (see recommendation 130).

44. This means, among other things, that the right of a secured creditor to enforce a security right in a negotiable document and, consequently, in the tangible assets covered by it, is limited by the law governing negotiable documents in two ways. The first limitation is that the assets covered by the negotiable document must still be in the hands of the issuer or other obligor under that document at the time of enforcement.

45. The second limitation is that the issuer's or other obligor's obligation to deliver the assets typically runs only to the person to which the document was initially issued or to any subsequent holder of the document (as determined by the law governing negotiable documents). If the negotiable document was not transferred to the secured creditor in accordance with the law governing negotiable documents, the issuer or other obligor will have no obligation to deliver the assets to the secured creditor. For example, if under negotiable documents law, the document must bear an endorsement at the time it is transferred in order for the transferee to be entitled to receive the assets covered by the document and the transferee holds a document without such an endorsement, the obligor need not deliver the assets covered by the document. In such a case, the secured creditor may need to obtain an order from a court or other tribunal in order to obtain possession of the underlying tangible assets. Upon proof of the existence of a security agreement, the court order would normally require the transfer of the document or, in the case of a secured creditor that already has possession of the document, endorsement of the document to the secured creditor or to a person designated by the secured creditor. In some cases, the court order might dispense with the formality of requiring an endorsement by the grantor and simply order the issuer or other obligor to deliver the assets covered by the document to the secured creditor or other person designated by the secured creditor.

B. Recommendations 117-130

Purpose

The purpose of provisions on the rights and obligations of third-party obligors is to enhance the efficiency of secured transactions where the encumbered asset is a payment obligation or other performance owed by a third party to the grantor by:

(a) Providing rules relating to rights and obligations of parties to the assignment of a receivable and the protection of the debtor of the receivable;

(b) Providing rules to ensure the coherence of secured transactions law with other law relating to the rights and obligations arising under negotiable instruments and negotiable documents; and

(c) Providing rules to ensure the coherence of the secured transactions regime with other law governing the rights and obligations of depository banks, and of the guarantor/issuer, confirmer or nominated person under an independent undertaking.

1. Rights and obligations of the debtor of the receivable²

Protection of the debtor of the receivable

117. The law should provide that:

(a) Except as otherwise provided in this law, an assignment does not, without the consent of the debtor of the receivable, affect the rights and obligations of the debtor of the receivable, including the payment terms contained in the original contract; and

(b) A payment instruction may change the person, address or account to which the debtor of the receivable is required to make payment, but may not change:

(i) The currency of payment specified in the original contract; or

(ii) The State specified in the original contract in which payment is to be made to a State other than that in which the debtor of the receivable is located.

Notification of the assignment

118. The law should provide that:

(a) Notification of the assignment or a payment instruction is effective when received by the debtor of the receivable if it is in a language that is reasonably expected to inform the debtor of the receivable about its contents. It is sufficient if notification of the assignment or a payment instruction is in the language of the original contract;

(b) Notification of the assignment or a payment instruction may relate to receivables arising after notification; and

(c) Notification of a subsequent assignment constitutes notification of all prior assignments.

Discharge of the debtor of the receivable by payment

119. The law should provide that:

(a) Until the debtor of the receivable receives notification of the assignment, it is entitled to be discharged by paying in accordance with the original contract;

²For recommendations 117-123, see articles 15-21 of the United Nations Assignment Convention.

(b) After the debtor of the receivable receives notification of the assignment, subject to subparagraphs (c)-(h) of this recommendation, it is discharged only by paying the assignee or, if otherwise instructed in the notification of the assignment or subsequently by the assignee in a writing received by the debtor of the receivable, in accordance with such payment instruction;

(c) If the debtor of the receivable receives more than one payment instruction relating to a single assignment of the same receivable by the same assignor, it is discharged by paying in accordance with the last payment instruction received from the assignee before payment;

(d) If the debtor of the receivable receives notification of more than one assignment of the same receivable made by the same assignor, it is discharged by paying in accordance with the first notification received;

(e) If the debtor of the receivable receives notification of one or more subsequent assignments, it is discharged by paying in accordance with the notification of the last of such subsequent assignments;

(f) If the debtor of the receivable receives notification of the assignment of a part of or an undivided interest in one or more receivables, it is discharged by paying in accordance with the notification or in accordance with this recommendation as if the debtor of the receivable had not received the notification. If the debtor of the receivable pays in accordance with the notification, it is discharged only to the extent of the part or undivided interest paid;

(g) If the debtor of the receivable receives notification of the assignment from the assignee, it is entitled to request the assignee to provide within a reasonable period of time adequate proof that the assignment from the initial assignor to the initial assignee and any intermediate assignment have been made and, unless the assignee does so, the debtor of the receivable is discharged by paying in accordance with this recommendation as if the notification from the assignee had not been received. Adequate proof of an assignment includes but is not limited to any writing emanating from the assignor and indicating that the assignment has taken place; and

(h) This recommendation does not affect any other ground on which payment by the debtor of the receivable to the person entitled to payment, to a competent judicial or other authority, or to a public deposit fund discharges the debtor of the receivable.

Defences and rights of set-off of the debtor of the receivable

120. The law should provide that:

(a) In a claim by the assignee against the debtor of the receivable for payment of the assigned receivable, the debtor of the receivable may raise against the assignee all defences and rights of set-off arising from the original contract, or any other contract that was part of the same transaction, of which the debtor of the receivable could avail itself as if the assignment had not been made and such claim were made by the assignor;

(b) The debtor of the receivable may raise against the assignee any other right of set-off, provided that it was available to the debtor of the receivable at the time notification of the assignment was received by the debtor of the receivable; and

(c) Notwithstanding subparagraphs (a) and (b) of this recommendation, defences and rights of set-off that the debtor of the receivable may raise pursuant to recommendation 24, subparagraph (b), or recommendation 25, subparagraph (e) (chapter II on the creation of a security right), against the assignor for breach of an agreement limiting in any way the assignor's right to make the assignment are not available to the debtor of the receivable against the assignee.

Agreement not to raise defences or rights of set-off

121. The law should provide that:

(a) The debtor of the receivable may agree with the assignor in a writing signed by the debtor of the receivable not to raise against the assignee the defences and rights of set-off that it could raise pursuant to recommendation 120. Such an agreement precludes the debtor of the receivable from raising against the assignee those defences and rights of set-off;

(b) The debtor of the receivable may not waive defences:

- (i) Arising from fraudulent acts on the part of the assignee; or
- (ii) Based on the incapacity of the debtor of the receivable; and

(c) Such an agreement may be modified only by an agreement in a writing signed by the debtor of the receivable. The effect of such a modification as against the assignee is determined by recommendation 122, subparagraph (b).

Modification of the original contract

122. The law should provide that:

(a) An agreement concluded before notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is effective as against the assignee, and the assignee acquires corresponding rights;

(b) An agreement concluded after notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is ineffective as against the assignee unless:

- (i) The assignee consents to it; or
- (ii) The receivable is not fully earned by performance and either the modification is provided for in the original contract or, in the context of the original contract, a reasonable assignee would consent to the modification; and

(c) Subparagraphs (a) and (b) of this recommendation do not affect any right of the assignor or the assignee arising from breach of an agreement between them.

Recovery of payments

123. The law should provide that failure of the assignor to perform the original contract does not entitle the debtor of the receivable to recover from the assignee a sum paid by the debtor of the receivable to the assignor or the assignee.

2. Rights and obligations of the obligor under a negotiable instrument

124. The law should provide that a secured creditor's rights under a negotiable instrument are, as against a person obligated on the negotiable instrument, subject to the law governing negotiable instruments.

3. Rights and obligations of a depositary bank

125. The law should provide that:

(a) The creation of a security right in a right to payment of funds credited to a bank account does not affect the rights and obligations of a depositary bank without its consent; and

(b) Any rights of set-off that a depositary bank may have under other law are not impaired by reason of any security right that the depositary bank may have in a right to payment of funds credited to a bank account.

126. The law should provide that it does not obligate a depositary bank:

(a) To pay any person other than a person that has control with respect to funds credited to a bank account;

(b) To respond to requests for information about whether a control agreement or a security right in its own favour exists and whether the grantor retains the right to dispose of the funds credited in the account; or

(c) To enter into a control agreement.

4. Rights and obligations of the guarantor/issuer, confirmer or nominated person of an independent undertaking

127. The law should provide that:

(a) A secured creditor's right in the right to receive the proceeds under an independent undertaking is subject to the rights, under the law and practice governing independent undertakings, of a guarantor/issuer, confirmer or nominated person and of any other beneficiary named in the undertaking or to whom a transfer of the right to draw has been effected;

(b) The rights of a transferee of an independent undertaking are not affected by a security right in the right to receive the proceeds under the independent undertaking created by the transferor or any prior transferor; and

(c) The independent rights of a guarantor/issuer, confirmer, nominated person or transferee of an independent undertaking are not adversely affected by reason of any security right it may have in the right to receive proceeds under the independent undertaking.

128. The law should provide that a guarantor/issuer, confirmer or nominated person is not obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the right to receive the proceeds under an independent undertaking.

129. The law should provide that, if a secured creditor obtains control by becoming an acknowledged assignee of the proceeds under an independent undertaking, the secured creditor has the right to enforce the acknowledgement against the guarantor/issuer, confirmer or nominated person that made the acknowledgement.

5. Rights and obligations of the issuer of a negotiable document

130. The law should provide that a secured creditor's rights under a negotiable document are, as against the issuer or any other person obligated on the negotiable document, subject to the law governing negotiable documents.

VIII. Enforcement of a security right

A. General remarks

1. Introduction

1. Parties to any agreement usually expect each other to perform all their obligations voluntarily, whether the obligations are owed between themselves or to third parties and whether they arise by contract or by operation of law. Only where performance is not forthcoming do parties contemplate compulsory enforcement through a judicial procedure. Typically, States carefully develop enforcement regimes for ordinary civil actions that balance the rights of debtors, creditors and third parties. In most States, these regimes require a creditor seeking to enforce performance to bring a court action to have the claim recognized and then to have the debtor's assets seized and sold under the supervision of a public official. From the amount generated by the sale, the judgement creditor will receive payment of its outstanding claim against the judgement debtor.

2. Parties to a security agreement have similar expectations of each other. A secured creditor usually presumes that a grantor will perform its obligations voluntarily. Likewise, a grantor will typically expect the secured creditor to fulfil the obligations it has undertaken. Both enter the transaction fully intending to meet their obligations to each other. Yet both also recognize that there will be times when they may not be able to do so. Sometimes, the secured creditor will fail to make a promised payment or to return assets to a grantor when an agreed condition for doing so occurs. In such cases, the grantor will normally apply to the court for relief. Most often, however, it is the grantor that finds itself incapable of performing as promised (that is, unable to repay the credit according to the terms of the agreement). The failure will sometimes flow from reasons beyond the grantor's control, such as an economic downturn in an industry or more general economic conditions. Sometimes, it may result from defaults by the grantor's own debtors. Sometimes, the grantor cannot perform owing to bona fide business misjudgements or as a consequence of poor management.

3. Whatever the reason, even after one or more payments have been missed, it is in the interest of both parties to a security agreement and of third parties generally that the grantor attempt to make up these payments and continue voluntarily to perform the promised obligation. Compulsory enforcement proceedings are always less efficient than voluntary performance since: (a) they are costly; (b) they take time; (c) the outcome is not always certain; (d) they usually lead to a complete breakdown in the relationship between the parties; and (e) the longer-term consequences for grantors and third parties are often devastating (and may include cessation of the grantor's business or insolvency proceedings). This is why many States actively encourage parties to a security agreement to take steps to avoid a failure of performance that would lead to compulsory enforcement. Moreover, this is why secured creditors often will closely monitor their grantors' business activities. For example, they will periodically review account books, inspect the encumbered assets and communicate with those grantors that show signs of financial difficulty.

Grantors having trouble meeting their obligations will often cooperate with their secured creditors to work out ways to forestall or to overcome their difficulties. In some cases, a grantor may request a secured creditor's assistance in developing a new business plan. In other cases, a grantor and an individual creditor or a grantor and its whole group of creditors working together may attempt informally to readjust aspects of their agreements.

4. There are many types of debt-readjustment agreement. Sometimes the parties enter into what is known as a "composition" or "work-out" arrangement that extends the time for payment, otherwise modifies the grantor's obligation or adds or reduces encumbered assets that secure the obligation. Negotiations to reach a composition or work-out arrangement take place against a background of two main factors: (a) the secured creditor's right to enforce its security rights in the encumbered assets if the grantor defaults on its secured obligation; and (b) the possibility that the grantor will be forced out of business or that insolvency proceedings will be initiated by or against the grantor.

5. Nevertheless, despite the best efforts of grantors and secured creditors to avoid compulsory enforcement proceedings, they will sometimes be unavoidable. One of the key issues for States enacting secured transactions regimes is, consequently, to decide the scope of a creditor's post-default rights. More specifically, the question is what modifications, if any, States should make to the normal rules that apply to the enforcement of contractual rights when developing rules to govern how security rights can be enforced when the grantor fails to perform the secured obligation.

6. At the heart of a secured transactions regime is the right of the secured creditor to look to the amount that can be realized upon the sale of the encumbered assets to satisfy the secured obligation. Enforcement mechanisms that allow creditors to predict accurately the time and cost involved in disposing of the encumbered assets and the proceeds likely to be received from the enforcement process will have a significant positive impact on the availability and the cost of credit. A secured transactions regime should, therefore, provide efficient, economical and predictable procedural and substantive rules for the enforcement of a security right after a grantor has defaulted. At the same time, because enforcement will directly affect the rights of the grantor, other persons with a right in the encumbered assets and the grantor's other creditors, a secured transactions regime should also provide reasonable safeguards to protect their rights.

7. All interested parties benefit from maximizing the amount achieved from the sale of the encumbered assets. The secured creditor benefits by the potential reduction of any amount that the grantor may owe as an unsecured obligation after application of the proceeds of enforcement to the outstanding secured obligation (known as a "deficiency" or "shortfall"). At the same time, the grantor and the grantor's other creditors benefit from a smaller deficiency or a larger amount remaining after satisfaction of the secured obligation (a "surplus").

8. This chapter examines the secured creditor's right to enforce its security right if the grantor fails to perform (defaults on) the secured obligation. If the grantor is insolvent, insolvency law may limit the exercise of these rights (see chapter XII on the impact of insolvency on a security right). In section A.2 of this chapter, the general principles guiding default and enforcement are discussed. Section A.3 reviews the procedural steps that a secured creditor may be required to follow prior to exercising its remedies and sets out

the grantor's post-default rights. The different remedies typically available to secured creditors are examined in section A.4. In section A.5, the effects of enforcement on grantors, secured creditors and third parties are considered. The enforcement of a security right in proceeds is discussed in section A.6. The intersection of the enforcement regimes relating to movable assets and immovable property is discussed in section A.7. Finally, the types of adjustment that may be necessary for effective enforcement against attachments to movable assets, masses and products are discussed in section A.8.

9. The enforcement of security rights in receivables, negotiable instruments, rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking and negotiable documents does not fit easily into the general procedures for enforcement against tangible assets. As a result, many States have particular rules dealing with enforcement against intangible assets in general, and receivables and various other rights to payment in particular. These special situations are discussed in sections B.1 to B.7 of this chapter. The chapter concludes, in section C, with a series of recommendations.

2. *General principles of enforcement*

(a) *General*

10. As noted in the preceding section, it is in everyone's interest that the grantor voluntarily performs its promised obligation. For this reason, when performance is not forthcoming, the secured creditor and the grantor normally will attempt to enter into an agreement that obviates the need to commence compulsory enforcement proceedings. Seldom will a grantor be unaware that it is not performing its obligations, and even more rarely, if ever, will the grantor learn for the first time that it is in default by means of a formal indication to this effect from the secured creditor. Indeed, in the latter case, enforcement proceedings usually do not follow since the failure of performance will almost always have been due to inadvertence rather than an inability or unwillingness to pay. Still, compulsory enforcement will sometimes become necessary. When it does, a number of basic principles guide States in elaborating the post-default rights and obligations of secured creditors and grantors.

(b) *Requirement for default to have occurred prior to enforcement*

11. A security right secures the performance of a grantor's (or, in the case of a third-party grantor, the debtor's) obligation to the secured creditor. In the standard case, therefore, the security right becomes enforceable as soon as the grantor (or the debtor, if the grantor is a third party) fails to pay the secured obligation. There are, however, a number of other events constituting default that are typically set out in the security agreement. Any one of these events, unless waived by the secured creditor, is sufficient to constitute a default, thereby permitting compulsory enforcement of the security right. In other words, the parties' agreement and the general law of obligations will determine whether the grantor is in default and when enforcement proceedings may be commenced. This general law of obligations will usually also determine whether a formal notice of default must be given to the grantor (or the debtor) and, if so, what the content of that notice will be.

12. Occasionally, default occurs not because a payment has been missed, but because another creditor either seizes the encumbered assets under a judgement or seeks to enforce its own security right. Some States provide that, whether or not there is any stipulation to this effect in individual security agreements, the seizure of encumbered assets by any other creditor constitutes a default under all security agreements that encumber the seized assets. The rationale is based on efficiency. As the encumbered asset is the creditor's guarantee of payment, whenever that asset is subject to judicial process the secured creditor should be able to intervene to protect its rights. In these cases, procedural law will often give these other creditors the right to force the disposition of encumbered assets. The secured creditor will look to this same procedural law for rules on intervening in these judicial actions and enforcement proceedings in order to protect its rights and its priority.

13. Typically, States provide that a secured creditor with a higher-ranking priority (a senior creditor) will be able to take over the enforcement process from another creditor (for example, a secured creditor or a judgement creditor that has taken steps to enforce its rights) with a lower priority ranking (a junior creditor), should it so choose. This rule follows because the two secured creditors will be enforcing similar rights under the same security regime and the enforcement rights of these creditors should, therefore, be determined by their respective priority. Other States protect the rights of senior creditors by providing that any enforcement sale by a junior creditor cannot affect the rights of the senior creditor.

14. In some States, once enforcement of a judgement claim has commenced, the secured creditor may not intervene to enforce its rights under the security agreement. This approach is usually followed in States where a judicial sale extinguishes (that is, purges) all rights, including security rights, from the assets that have been sold. The assumption is that, because the judicial sale enables the purchaser to acquire a clean title, it will produce the highest enforcement value. In other States, however, where a secured creditor has rights in some or all of the assets under seizure by a judgement creditor, the secured creditor is permitted to counter the seizure and enforce its security rights by any means available to it. This approach is usually found in States where a regular judicial sale in execution does not extinguish security rights. The assumption is that a higher amount is likely to be realized from the disposition by permitting creditors to enforce a security right because, in such a case, the enforcement process leads to the purchaser obtaining, if not a clear title, at least a title that is clearer than would be possible under a judicial sale. For example, if a judicial sale does not purge any security rights but enforcement by a secured creditor will extinguish all junior rights, a sale by a secured creditor (even the most junior creditor) will extinguish at least its security right. What is more important is that enforcement by the most senior secured creditor allows the purchaser to obtain a clear title (see paras. 77-80 below).

(c) Good faith and commercial reasonableness

15. Enforcement of a security right has serious consequences for grantors, debtors and interested third parties (such as a junior secured creditor, a guarantor or a co-owner of the encumbered assets). For this reason, some States impose, as a general and overriding obligation of secured creditors, a specific duty to act in good faith and follow commercially reasonable standards when enforcing their rights. Because of the importance of this

obligation, these States also provide that at no time may the secured creditor and the grantor waive or vary it (see recommendations 131 and 132). Moreover, as noted, a secured creditor that does not comply with enforcement obligations imposed on it will be liable for any damages caused to the persons injured by its failure (see recommendation 136). For example, if a secured creditor does not act in a commercially reasonable manner in disposing of the encumbered assets and that results in the secured creditor obtaining a smaller amount than a commercially reasonable disposition would have produced, the secured creditor will owe damages to any person harmed by that differential.

(d) Freedom of parties to agree on the enforcement procedure

16. States generally impose very few pre-default obligations on parties to a security agreement (see chapter VI on the rights and obligations of the parties to a security agreement). A key issue in the post-default enforcement context is, consequently, whether a similar policy should prevail. In other words, the issue is to determine the degree to which the secured creditor and the grantor should be permitted to modify either the statutory framework for enforcing security rights or their respective contractual rights as set out in the security agreement. Some States consider the enforcement procedure to be part of mandatory law that the parties cannot modify by agreement. In other States, the parties are allowed to modify the statutory framework for enforcement as long as public policy, priority and third-party rights (in particular in the case of insolvency) are not affected. In yet other States, emphasis is placed on efficient enforcement mechanisms in which judicial enforcement is not the exclusive or the primary procedure. In those States, there may be limits on the extent to which the secured creditor and the grantor may agree to modify the statutory framework in their security agreement, because the freedom to vary an enforcement obligation may be the subject of abuse at the time the parties enter into the security agreement. Despite these limits, some States permit the parties to waive or modify their rights under the security agreement at any time thereafter. Other States only permit waiver after a default occurs.

17. States that permit parties to waive their legal or contractual post-default rights by agreement nonetheless typically impose a number of restrictions on their capacity to do so. For example, they generally do not permit waiver of the creditor's obligation to act in good faith and in a reasonably commercial manner (see recommendation 132). As for other obligations, many States distinguish between the rights of the grantor and those of the secured creditor. In some States, the grantor may waive or agree to vary the secured creditor's post-default obligations only after a default has occurred. Allowing a waiver after default often enables the grantor and the secured creditor to negotiate a disposition of the encumbered assets in a manner that maximizes the amount that can be realized for the benefit of the secured creditor, the grantor and the other creditors of the grantor (see recommendation 133). These same States usually also permit a secured creditor to waive its rights against the grantor at any time (either prior to or after default) on the assumption that there is little risk that abusive terms would be imposed by the grantor at the time the credit is being extended (see recommendation 134). In any case, a variation of rights by the parties to a security agreement cannot affect the rights of third parties (see recommendation 135, first sentence). In such cases, however, any person challenging the agreement as being contrary to the mandatory provisions just noted has the burden of proving non-compliance (see recommendation 135, second sentence).

(e) *Judicial supervision of enforcement*

18. Generally speaking, when a grantor is in default and all attempts to compose or work out the obligations have failed, compulsory enforcement against the encumbered assets is likely to ensue. In some cases, however, a grantor will contest either the secured creditor's claim that it is in default or the secured creditor's calculation of the amount owed as a result of the default. As a matter of public policy, States generally provide that grantors are always entitled to request courts to confirm, reject, modify or otherwise control the exercise of a creditor's enforcement rights.

19. The point is not to burden secured creditors with unnecessary judicial procedures, but rather to enable grantors and other interested parties to ensure respect for mandatory post-default procedures (see recommendation 137). Consequently, to ensure that grantor challenges to enforcement can be dealt with efficiently in terms of both time and cost, many States replace the normal rules of civil procedure with expedited judicial proceedings in these cases (see recommendation 138). For example, grantors and other interested parties may be given only a limited time within which to make a claim or raise a defence. Other States permit grantors to challenge the secured creditor on these issues even after enforcement has commenced, at the time proceeds of enforcement are distributed or when the secured creditor seeks to collect any deficiency. Still other States permit grantors to obtain not only compensatory damages but also punitive damages should it be shown that the secured creditor either had no right to enforce or enforced for an amount greater than that actually owed.

20. Furthermore, because all such challenges will delay enforcement and add to its cost, many States also build safeguards into the process to discourage grantors from making unfounded claims. These include procedural mechanisms, such as adding the costs of the proceedings to the secured obligation in the event that they are unsuccessful, or requiring affidavits from grantors as a prerequisite to launching such proceedings. Some States also permit secured creditors to seek damages against grantors that bring frivolous proceedings or fail to comply with their obligations and to add these damages to the secured obligation. The *Guide* recommends that compensatory damages be available if either the grantor or the secured creditor fails to comply with any of its post-default obligations (see recommendation 136).

(f) *Scope of post-default rights of the grantor*

(i) *General*

21. As already mentioned (see para. 18 above), the grantor may seek relief from the courts if the secured creditor does not exercise its post-default rights in accordance with the security agreement and the law. The grantor may also pay the secured obligation in full and obtain a release of the encumbered assets (see paras. 22-26 below). In addition, the grantor may propose to the secured creditor to take the encumbered assets in total or partial satisfaction of the secured obligation or object to such a proposal if made by the secured creditor (see paras. 65-70 below) and may exercise any other remedy provided for in the security agreement or the law (see recommendation 139). The grantor may also object to the extrajudicial taking of possession by the secured creditor or to the extrajudicial disposition of the encumbered assets (see recommendations 142, 147 and 148; see also paras. 29-32 and 57-60 below).

(ii) *Extinction of the security right after full payment of the secured obligation*

22. Once a default has been signalled, the debtor, third-party grantor and interested third parties will often attempt to refinance the secured obligation or otherwise remedy the alleged default. In such cases, States must decide what rights these different parties may exercise and within what time frame these rights may be exercised. Typically, grantors and third parties are given the right to obtain a release of the encumbered assets from the security right upon full repayment of the secured obligation and termination of any commitment to provide further credit.

23. Full payment of the secured obligation and termination of any credit commitment extinguishes the security right and brings the secured transaction to an end. As the objective of enforcement proceedings is to enable creditors to obtain repayment of the obligation, States are usually quite flexible about which parties are entitled to pay the secured obligation. For example, most States permit a defaulting grantor to seek to obtain a release of the encumbered assets before their final disposition by the secured creditor by paying the outstanding amount of the secured obligation, including interest and the costs of enforcement incurred up to the time of repayment. These States usually also permit any interested third party (such as a creditor with a lower priority ranking than that of the enforcing creditor, or a purchaser that takes the assets subject to the security right) to exercise the right of repayment if the grantor does not do so. Thus, for example, a creditor with a lower priority ranking than that of the enforcing creditor or a purchaser that takes the assets subject to the security right may pay the secured obligation in the grantor's stead.

24. In addition, States usually take a flexible position in relation to the time within which repayment may be made. The secured creditor's interest is in being paid, as opposed to disposing of the encumbered asset. As long as the payment of principal, interest and costs incurred for enforcement occurs before any third-party rights are affected, there is no reason for insisting on disposition of the encumbered asset. This means that whoever exercises the right to repay may do so until the secured creditor: (a) disposes of the encumbered asset or completes collection after disposition of the encumbered asset; (b) enters into an agreement to dispose of the encumbered asset; or (c) acquires the encumbered asset in total or partial satisfaction of the secured obligation. Until one of these events takes place, the secured obligation may be repaid in full and the encumbered assets released from the security right. For the same reasons (recognizing that the creditor's primary interest is in receiving payment and the grantor's primary interest is in not losing its assets), the *Guide* recommends that repayment leading to release of the encumbered assets be permitted right up until third-party rights are acquired, an agreement for the disposition of the assets has been concluded or the secured creditor has acquired the encumbered assets in satisfaction of the secured obligation (see recommendation 140).

25. Another post-default right given to grantors in some States is the right to reinstate the secured obligation upon payment of any arrears. Reinstatement of the secured obligation is quite different from the extinction of the security right and is usually more narrowly circumscribed. Reinstating the secured obligation means curing the specific default by paying any missed instalments, accrued interest and costs of enforcement already incurred, but otherwise it has no effect either on the grantor's continuing duty to perform or on the security right. In particular, where States permit reinstatement and reinstatement takes place, the effect is to nullify the effect of an acceleration of the secured obligation

pursuant to an acceleration clause. This means that, if a secured creditor wishes to avail itself of an acceleration clause without the risk of reinstatement of the secured obligation, it can only do so by bringing a regular judicial action to have the accelerated agreement enforced and the encumbered assets seized and sold. Once reinstated, the obligation remains enforceable according to the terms agreed by the parties and remains secured by the encumbered assets.

26. States take quite different approaches to the reinstatement right. Some do not legislatively provide for a reinstatement right, but allow parties to provide for such a right in the security agreement. By contrast, some States provide that reinstatement is a right given by law that may not be waived by the grantor either prior to or after default. Some States permit any interested party to cure a default and reinstate the secured obligation, while most States provide that the right may only be exercised by the grantor. Whenever a right of reinstatement is permitted, parties authorized to exercise the right may do so up to the same time that parties authorized to remedy the default by full payment are entitled to exercise that right. As reinstatement maintains rather than extinguishes the secured obligation, the grantor may later again fall into default. To prevent a series of strategic defaults and reinstatements, States that permit reinstatement usually limit the number of times that a secured obligation may be reinstated after default. The *Guide* does not contain a specific recommendation concerning reinstatement. The main reason for this approach is that the decision whether to permit acceleration clauses in security agreements (which would make the reinstatement right moot) is considered to be more properly a matter to be addressed by a State's general law of obligations.

(g) Scope of post-default rights of the secured creditor

27. A general creditor that obtains a judgement may enforce the judgement against all the debtor's assets that procedural law allows to be seized. This usually will include all the debtor's assets of whatever kind. If the debtor has only a limited right in assets, only that limited right (such as a usufruct) may be seized and sold. Similarly, if a debtor's rights in assets are limited by a term or a condition, the enforcement against the asset will be likewise limited. The purchaser at the judicial sale may only acquire the asset subject to the same term or condition.

28. Unlike the case of ordinary enforcement of judgements, the enforcement of security rights is subject to an important additional limitation. A secured creditor may only proceed against the assets actually encumbered by its security right and not against the grantor's entire estate. Of course, the secured creditor may also exercise any remedies available to an unsecured creditor to claim a deficiency against the grantor in the event that the value of the encumbered assets proves insufficient to pay the obligation in full. Apart from this additional constraint, principles similar to those governing enforcement of judgements in general apply to the enforcement of a security right. The secured creditor may only enforce the security right against the particular property rights that the grantor actually has in the encumbered assets. Thus, for example, if a grantor's ability to sell or otherwise dispose of, lease or license an encumbered asset is limited, the secured creditor's enforcement may not override those restrictions. This means that, for example, if a grantor is a lessee under an operating lease of a piece of equipment, the security right would encompass only the grantor's right as a lessee under the terms of the lease agreement.

(h) *Judicial and extrajudicial enforcement*

29. As a general principle of debtor-creditor law, most States require claims to be enforced by judicial procedures. Creditors must sue their debtors, obtain judgement and then resort to other public officials or authorities (for example, bailiffs, notaries or the police) to enforce the judgement. In order to protect the grantor and other parties with rights in the encumbered assets, some States impose a similar obligation on secured creditors, requiring them to resort exclusively to the courts or other governmental authorities to enforce their security rights. However, as court proceedings can be slow and costly, often these proceedings are less likely to produce the highest possible amount upon the disposition of the assets being sold. In addition, because the anticipated delay and expenses involved in enforcement will be factored into the decision whether to provide financing and the cost of such financing, inefficient processes will have a negative impact on the availability and the cost of credit.

30. To facilitate secured transactions, some States require only a minimal prior intervention by public officials or authorities in the enforcement process. For example, the secured creditor may be required to apply to a court for an order of repossession, which the court will issue without a hearing. In other cases, once the secured creditor is in possession of the asset, it may sell it directly without court intervention as long as it hires a certified bailiff to manage the process according to prescribed procedures. The justification for a less formal approach lies in the fact that having the secured creditor or a trusted third party take possession and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. A properly designed system can provide an efficient mechanism for maximizing the amount that can be achieved from the sale of the encumbered assets and thus protect the grantor and other persons with an interest in maximizing the amount obtained from the sale of the encumbered assets. Moreover, the knowledge that judicial intervention is readily available is often sufficient to create incentives for cooperative and reasonable behaviour that obviates the need to resort to the courts. Finally, unlike the typical judgement creditor, most secured creditors are in the business of providing credit. Hence, a secured creditor's concerns about its reputation among potential future borrowers will normally impose constraints on its enforcement behaviour.

31. In some States, the secured creditor is not required to use the courts or other governmental authorities for any enforcement purposes, but is entitled to make exclusive use of extrajudicial procedures. However, these States usually impose a number of mandatory rules concerning extrajudicial enforcement. Examples of such rules include rules relating to the obligation of the secured creditor to send a notice of default or notice of intended disposition, the obligation to act in good faith and in a commercially reasonable manner and the obligation to account to the grantor for the proceeds of disposition. In addition, these States do not permit the secured creditor to take possession of the encumbered assets extra judicially if such enforcement would result in a breach of the peace or other disturbance of the public order. The purpose and effect of these requirements is to provide for flexibility in the methods used to dispose of the encumbered assets so as to achieve an economically efficient enforcement process, while at the same time protecting the grantor and other interested parties against actions taken by the secured creditor that, in the commercial context, are not reasonable. The *Guide* recommends that, in order to maximize flexibility in enforcement and thereby to obtain the highest possible price upon disposition, creditors should have the option of proceeding either judicially or extra judicially

when enforcing their security rights (see recommendation 142). In any event, in States that permit extrajudicial enforcement, the courts generally are always available to ensure that legitimate claims and defences of the grantor and other parties with rights in the encumbered assets are recognized and protected. This is also the approach adopted in the *Guide* (see recommendation 137).

32. As noted in the preceding paragraph, even in States where a secured creditor is permitted to act without official intervention, it is normally also entitled to enforce its security right through the courts. Moreover, because a security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation, post-default enforcement of the security right should not preclude a secured creditor from attempting to enforce the secured obligation by ordinary judicial process followed by seizure and sale in execution of the judgement obtained (see recommendation 144). There are a number of reasons why a secured creditor might choose either of these options over extrajudicial enforcement. The secured creditor may wish to avoid the risk of having its actions challenged after the fact. It may conclude that it will have to apply for a judicial proceeding anyway in order to recover an anticipated deficiency; or it may fear, and wish to avoid, a breach of the public order at the time of enforcement.

33. Many States actually encourage secured creditors to use the courts by providing for less costly and more expeditious enforcement proceedings. They may, for example, permit enforcement through a process involving only affidavit evidence. They may also provide for rules ensuring that the hearing must be held, challenges must be disposed of and a decision rendered as expeditiously as possible. Some States even permit a secured creditor that has obtained a judgement in the ordinary way to seize and dispose of the encumbered assets without having to use the official seizure and sale process. Finally, most States provide that the creditor retains the discretion to pursue whatever enforcement procedures it considers most appropriate. So, for example, a secured creditor that elects to pursue a particular extrajudicial remedy may change its mind and later pursue another extrajudicial remedy to enforce its security rights to the extent that the exercise of a right does not make the exercise of another right impossible (see recommendation 143 and paras. 34 and 35 below).

(i) Post-default rights cumulative

34. It will sometimes happen that, in order to dispose completely of all the encumbered assets, a creditor will be obliged to exercise more than one remedy. This typically occurs when a secured creditor liquidates an entire business that is comprised of different types of asset, because different types of encumbered asset lend themselves to different enforcement procedures. For example, a security right in receivables may be most effectively enforced through collection of the receivables, while a security right in inventory or equipment may be most effectively enforced through a sale of the inventory and equipment. In other cases, a security right in particular assets may be most effectively enforced through the acquisition of the assets by the secured creditor in satisfaction of the secured obligation. In addition, there will occasionally be situations where a secured creditor believes that one remedy will be optimal, only to discover that another will generate a higher amount upon disposition. This is why most States provide that a secured creditor's remedies are cumulative. In States that take this approach, the enforcing creditor may not only have the option of selecting

which remedy to pursue, it may also exercise different remedies either at the same time or one after the other. It may even concurrently pursue both judicial and extrajudicial remedies. Only where the exercise of one remedy (for example, repossession and disposition of an encumbered asset) makes it impossible to exercise another remedy (for example, acquisition of an encumbered asset in satisfaction of the secured obligation) will the creditor not be able to cumulate remedies. Here also, the *Guide* adopts the policy that maximizing flexibility in enforcement is likely to ensure that the highest value is received for the encumbered assets and recommends that secured creditors should be permitted to cumulate their judicial and extrajudicial remedies (see recommendation 143).

35. Some States do not permit secured creditors to cumulate both their remedies (judicial or extrajudicial) with respect to the encumbered assets and their remedies with respect to the secured obligation. The assumption is that the extrajudicial remedies are a favour given to the secured creditor and that the creditor ought, therefore, to be required to opt either to enforce the security right extra judicially or bring a judicial action to enforce the secured obligation. Other States permit the secured creditor to cumulate both its extrajudicial remedies and its right to enforce the obligation as a matter of contract law. Moreover, they permit the two proceedings to be brought concurrently or serially in either order. To require a secured creditor to opt, at the outset of enforcement, for one or the other mode of proceedings will complicate and increase the cost of enforcement because it will require a creditor to determine if a deficiency is likely to result. If the secured creditor comes to that conclusion, it will be obliged to bring an action to enforce the obligation and assert the priority that flows from the security right at the time of a judicial sale in enforcement. This process is less expeditious, more costly and will normally produce less value at the time of sale. To maximize enforcement value, the *Guide* recommends that secured creditors be permitted to cumulate proceedings to enforce the security extra judicially and to enforce the secured obligation through a judicial process, subject always to the limitation that the secured creditor cannot claim more than it is owed (see recommendation 144).

(j) *Right of the secured creditor with priority to take over enforcement*

36. A secured creditor that has a higher priority will often wish to take over an enforcement process commenced by another creditor. This could occur, for example, where judgement enforcement proceedings are being pursued by a junior creditor exercising a security right. Some States usually provide for a right to take over enforcement where another secured creditor is enforcing under secured transactions law, but many do not permit secured creditors to pursue extrajudicial enforcement once a judgement creditor (whether an unsecured judgement creditor or a secured creditor that may have also pursued judicial enforcement proceedings) has commenced a seizure of the encumbered assets. Sometimes, however, the right to take over enforcement is given to a secured creditor even as against enforcement by a judgement creditor. In these situations, States often require the secured creditor to exercise the right in a timely manner (that is, before the auction begins) and to reimburse the judgement creditor for enforcement expenses incurred up to that time. In order to maximize the efficiency of enforcement of security rights, the *Guide* recommends that a secured creditor with a priority ranking higher than that of the enforcing secured creditor be entitled to take over enforcement both as against other secured creditors pursuing extrajudicial

enforcement and as against judgement creditors (see recommendation 145). Under the *Guide*, this right may be exercised at any time before the earlier of the disposition, acquisition or collection of the encumbered asset or the conclusion of an enforceable agreement to dispose of the assets. In exercising such right to control enforcement, the senior secured creditor is not limited to pursuing the enforcement method already commenced by the junior creditor and may enforce its security right using any method available under the *Guide*.

3. *Procedural steps preceding enforcement and the rights of the grantor*

(a) *General*

37. Many States have developed comprehensive procedural mechanisms to facilitate effective and efficient enforcement by the secured creditor and protection of the rights of the grantor and third parties with a right in the encumbered assets. Generally, a secured creditor may: (a) obtain a judgement in the regular way, have a public official seize the encumbered assets and sell them at a public auction; (b) exercise an expedited judicial remedy to have the debtor's default acknowledged and proceed immediately to have a public official seize and sell the encumbered assets; or (c) enforce its rights without judicial process. These procedural mechanisms are meant to ensure a balance between competing rights after default but prior to the effective exercise of the secured creditor's remedies. Hence, States usually provide that these procedural mechanisms apply regardless of whether enforcement is judicial or extrajudicial and regardless of the particular remedy selected by the secured creditor. This means that they would apply whether the secured creditor: (a) seizes and sells the encumbered assets privately, appropriating the proceeds of sale to the repayment of the outstanding obligation; (b) acquires the encumbered asset in payment of the secured obligation; or (c) takes over the debtor's business and operates it to pay the secured obligation.

(b) *Notice of intended extrajudicial enforcement*

38. Where a secured creditor elects to enforce the security agreement by bringing before the courts an ordinary action against the grantor with respect to the secured obligation, the normal rules of civil procedure (including those relating to notice of default and the opportunity for a hearing on the merits) will apply to both the judicial action itself and the post-judgement enforcement process. Usually, however, these procedural rules only apply directly to the formal processes of courts. This is why States that permit extrajudicial enforcement typically enact additional rules to govern such enforcement. The objective of these rules is to ensure that the rights of affected parties are adequately protected while at the same time providing for a maximum of flexibility in the enforcement process.

39. One of the most fundamental procedural safeguards pertaining to extrajudicial enforcement of security rights is adequate notice of the intended action. The acknowledged need for giving notice of extrajudicial enforcement confronts States with a fundamental policy choice about how enforcement should be initiated. In some States, a secured creditor must give advance notice of its intention to pursue extrajudicial enforcement even before seeking to obtain possession of the encumbered assets. This means that the secured creditor must

provide the grantor (and usually also third parties with a right in the encumbered assets) with a written notice specifying the default, the encumbered assets, the secured creditor's intention to demand possession of the assets and the time period within which the grantor must either remedy the default or surrender the assets (typically 15-20 days). Frequently, the notice must also indicate the particular remedy that the secured creditor intends to follow in disposing of the encumbered assets. In other States, the timing of the notice is deferred and its substantive content is often less detailed. For example, in these States the secured creditor is not required to give prior notice of its intention to take possession, but is entitled to immediate possession of the encumbered assets at the same time that it gives formal notice of default to the grantor. Once in possession, however, the secured creditor usually may not dispose of the assets without giving the grantor and interested third parties advance notice (typically 15-20 days) of the mode and manner of disposition that it proposes to follow if the grantor fails to remedy the default in the interim.

40. There are advantages and disadvantages to each of these approaches. The principal advantage of a regime that requires prior notice of the secured creditor's intention to enforce and take possession of the encumbered assets is that it alerts the grantor as to the need to protect its rights in the encumbered assets. This is especially important in cases where the grantor is not the debtor of the secured obligation. Invariably, the debtor will be aware of its default but the third-party grantor may not be, and would be surprised by an immediate demand for possession from the secured creditor. The rights that the grantor could then exercise might include, for example, challenging the enforcement, curing the debtor's default or seeking potential buyers for the encumbered assets. Similar reasons underlie the idea of obliging the secured creditor to give notice to other interested parties. Receiving notice allows them to monitor subsequent enforcement by the secured creditor, to contest the enforcement or, if it is in their interest, to cure the default and, if they are secured creditors whose rights have priority (and the grantor is in default towards them as well), to participate in or take control of the enforcement process. The disadvantages of requiring this type of notice include its cost, the fact that the secured creditor may have to elect a remedy before close inspection of the encumbered assets, the opportunity it provides an uncooperative grantor to remove the encumbered assets from the creditor's reach and the possibility that other creditors will race to assert claims against the grantor's business and interfere with the disposition process. Moreover, unless formal and substantive requirements with respect to notices are clear and simple, there is a risk of technical non-compliance that will then generate litigation and its attendant cost and delay.

41. The advantage of a regime that requires only notice of extrajudicial disposition of the encumbered assets is that it facilitates the right of the secured creditor to take possession of the encumbered assets without undue delay, while protecting the interests of the grantor and third parties with rights in the encumbered assets (thereby overcoming the disadvantages of the approach mentioned in the preceding paragraph). The disadvantage is that the grantor is given notice of extrajudicial enforcement only after the secured creditor has already taken possession of the encumbered assets (thereby depriving the grantor of advance notice, as discussed in the preceding paragraph).

42. Regardless of which approach is taken, States must also decide what other notices may be required when a secured creditor seeks to enforce its security right extra judicially. Most States that require the creditor to give a pre-possession notice of its intention to enforce against the encumbered assets do not also require a separate prior notice of default

on the obligation or a subsequent notice of extrajudicial enforcement. The assumption is that a single notice will be sufficient for all purposes. Other States that permit the notice of the specific extrajudicial enforcement method being pursued to be given after the secured creditor obtains possession of the encumbered assets, nonetheless require the secured creditor to give a formal notice of default on the obligation before the creditor obtains possession of the assets. Some States do not oblige the secured creditor to give either notice of default on the obligation or pre-possession notice of intention to enforce. In these States, secured creditors need only give post-possession notice of the extrajudicial enforcement remedy they intend to pursue. To balance the interests of all parties, the *Guide* recommends that the secured creditor may take possession of the encumbered assets without applying to a court, provided that the grantor has consented to extrajudicial enforcement in the security agreement, the secured creditor has given the grantor and any person in possession of the encumbered asset notice of default and of its intention to seek to obtain possession out of court and, at the time the secured creditor seeks to obtain possession of the encumbered asset, neither the grantor nor the person in possession of the asset objects (see recommendation 147).

43. Requirements of the type just noted are intended to ensure that the enforcement process takes place without a disruption of the peace and without the grantor or third parties in possession of the encumbered assets being taken by surprise. In practice, however, enforcement is often less formal. This is because many States that impose such procedural requirements also permit grantors and other obligors to waive them, provided they do so after default. The main reasons for restricting the right to waive procedural rights to post-default situations are to avoid grantors being put under pressure to waive their procedural rights in order to obtain credit and to ensure that the grantor's decision to waive its rights is made in light of the circumstances existing at the time of default. The *Guide* also takes this position (see recommendation 133). As a result, after default has occurred, a secured creditor may ask a grantor or any other person in possession to surrender possession of encumbered assets without having stipulated for the right to obtain possession extra judicially in the security agreement and without having sent a prior notice of its intention to do so. If the grantor or other person in possession affirmatively consents to do so, the surrender of possession is permitted.

(c) Recipients, content, timing and form of the notice

44. As with other situations where notice may be required, States usually specify with considerable care the manner in which the notice is to be given, the persons to whom it must be given, the timing of the notice and its minimum contents. Many States distinguish between notice to the debtor, notice to the grantor when the grantor is not the debtor, notice to other creditors and notice to public authorities or the public in general. States normally undertake a cost-benefit analysis to determine whether the secured creditor should be required to give prior written notice to others beyond the debtor and grantor and other secured creditors that have registered a notice of their rights or that have otherwise notified the enforcing secured creditor of their rights. Some States provide that notice need be given only to the grantor and other secured creditors that have registered their rights or that have notified the enforcing secured creditor of their rights. Other States go further and require that the notice then be registered in the general security rights registry. The registrar is then required to forward the notice to all third parties other than secured

creditors that have registered rights against the encumbered assets. Other States only require the secured creditor to give notice to the grantor and to register the notice. These States impose on the registrar the duty to send the notice to all other parties that have registered rights against the encumbered assets.

45. States also take different approaches to the minimum content of the notice. As with the decision about the timing of the notice and its recipients, decisions about the information to be included require States to undertake a cost-benefit analysis. For example, States usually require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default. They might further require advice to the debtor or grantor regarding what steps to take to pay the secured obligation in full or, if such a right exists, to cure the default. Moreover, a few States provide that the notice given to other interested parties need not be as extensive or specific as the notice to the debtor and grantor. Where notice is to be given prior to taking possession, States sometimes require secured creditors to provide quite detailed information to grantors. Where notice is given after possession, by contrast, States usually provide that the secured creditor is obliged simply to give basic information about the date, time, location and type of disposition intended and the time period within which the grantor or any other interested party may contest the proposal or remedy the default.

46. There are different approaches to achieving the right balance between the need to ensure that the notice conveys to interested parties sufficient information to enable them to make an informed judgement about how best to protect their rights and the need to achieve expeditious and low-cost enforcement. Some States place a heavy burden on secured creditors, as to both the timing and the content of the notice. Others impose only minimal requirements. The *Guide* recommends that notice must be given prior to the secured creditor obtaining possession of the encumbered assets (see recommendation 147). If the secured creditor is already in possession, notice need not be given. Nonetheless, in either case the creditor must inform the grantor of the intended manner of realizing the encumbered assets. If the proposed remedy is extrajudicial sale, the notice must be given except in cases of urgency (because the assets are perishable or may decline in value speedily) or except if assets of the same type as the encumbered assets are customarily sold on a recognized market (see recommendation 149). Although secured transactions law should provide for notice to be given in a timely, efficient and reliable way, the *Guide* recommends that the requirements for the notice should not be so onerous as to have a negative impact on the secured creditor's rights or the potential net realizable value of the assets (see recommendation 150). Out of the same concern to achieve a balance between the interests of all parties, the *Guide* recommends that, if the secured creditor exercises the remedy to acquire the encumbered asset in full or partial satisfaction of the debt (see recommendation 156), the notice must permit the grantor sufficient time to object to the proposal (see recommendation 157).

47. In view of the purposes of giving notice, the notice must be understandable to the grantor. This is a particularly important requirement where the secured creditor and the grantor speak different languages. Many States require all notices to be given in the official language of that State. Sometimes, however, this language may not be understood by the grantor and interested third parties. For this reason, the *Guide* adopts, as a general principle, the idea that the notice should be in a language that can reasonably be expected to be understood by its recipients, although the use of the language of the security agreement should always be acceptable for this

purpose (see recommendation 151, subparagraph (c); for the language of the security agreement, see chapter II on the creation of a security right, para. 16; for the language of a notice, see chapter IV on the registry system, paras. 44-46; see also para. 70 below).

(d) Authorized disposition by the grantor

48. Following default, the secured creditor will be interested in obtaining the highest price possible for the encumbered assets. Frequently, the grantor will be more knowledgeable about the market for the assets than the secured creditor. For this reason, secured creditors will often permit the grantor to dispose of the encumbered assets even after enforcement has commenced. In most such cases, the parties agree that any amount received from the disposition will be paid to the secured creditor in the same manner as if payment resulted from enforcement proceedings. These arrangements have consequences for third parties that may also have rights in the encumbered assets or a right to the proceeds of their disposition. In order to protect these third-party rights, some States explicitly provide that when a secured creditor that has commenced enforcement gives the grantor a limited time following default to dispose of the encumbered assets, the proceeds of any sale by the grantor will, for all purposes, be treated as if they had arisen as a consequence of an enforcement disposition. A few States go further and even prohibit the secured creditor from attempting to arrange for the disposition of the encumbered assets during a short period of time following default. Other States seek to maximize the amount received upon disposition by providing incentives for the grantor to bring potential buyers to the attention of the secured creditor. In any event, the point is: (a) to structure the enforcement regime so as to give the grantor the incentive to cooperate with the secured creditor in disposing of encumbered assets for the highest possible price; and (b) to give the secured creditor the incentive to seek the highest possible price even when this exceeds the amount still owing on the secured obligation. The *Guide* recommends that the secured creditor may control the method, manner, time, place and other aspects of enforcement, thereby permitting the secured creditor to authorize the grantor to dispose of the encumbered assets (see recommendation 148, second sentence).

4. Extrajudicial enforcement of the rights of the secured creditor

(a) General

49. In cases where a secured creditor elects to enforce the security agreement judicially, it will be necessary for the secured creditor to seize and sell the encumbered assets after a judgement has been obtained. In some States, the normal rules of civil procedure relating to the post-judgement enforcement process will apply. Typically, this means that public officials or authorities (such as bailiffs, sheriffs, notaries or the police) will take possession of the encumbered assets and sell them in a public auction. In other States, even after a secured creditor has obtained a judgement, it may exercise its extrajudicial right to take possession of the encumbered assets and proceed to dispose of the assets extra judicially. In still other States, once a judgement has been obtained, the secured creditor must follow a judicial process, but a streamlined procedure for enforcing the judgement is provided.

50. Slightly different processes are required where a secured creditor elects to proceed with extrajudicial enforcement. As no public official is involved, the secured creditor will normally wish to obtain possession of the encumbered asset itself (and typically will have to do so) in order to proceed with enforcement. States have taken different policy approaches both as to the right of the secured creditor to obtain possession of assets (as opposed to consigning encumbered assets to a bailiff) and, if direct creditor possession is permitted, to the procedural mechanisms that must be followed for doing so.

(b) Removing the encumbered assets from the grantor's possession

51. Prior to default, the grantor will usually be in possession of the encumbered assets. Sometimes, however, the grantor will have already placed the secured creditor in possession, either at the time of making the security right effective between them or thereafter either as a means of achieving third-party effectiveness or in response to a later pre-default creditor's request to take possession of the assets. On other occasions, the encumbered assets may be in the possession of a third party that is acting for, or under the direction of, the secured creditor. In all these situations, many States do not require the secured creditor to give the grantor formal notice of default, but only to send a notice of intended disposition once the secured creditor has determined the recourse it intends to pursue. By contrast, some States require the creditor in possession to give the grantor notice of default. These States usually also consider that, upon default, any agreement under which the creditor in possession may use the encumbered assets comes to an end.

52. Where the secured creditor is not in possession, it must take active steps to recover the encumbered assets from the grantor or to inform a third party holding on behalf of the grantor that the security right has become enforceable. States that provide for extrajudicial enforcement generally provide that, once a grantor is in default, the secured creditor has an automatic right to possession of the encumbered assets. This means that they do not require that the assets be placed under the control of a public official pending extrajudicial enforcement. The assumption is that flexibility in enforcement and preservation of the assets at a lower cost pending disposition will result if the secured creditor can make decisions about where post-default possession should lie. This rationale also underlies the recommendation in the *Guide* that the secured creditor has, upon default, an automatic right to possession of a tangible encumbered asset (see recommendation 146).

53. A concomitant of the secured creditor's right to possession is its right to decide exactly how the rights flowing from that possession should be exercised. In some cases, secured creditors will themselves take physical possession of the encumbered assets against which they are proceeding. However, in many cases, they will not take possession of the assets. Secured creditors may, for example, have the assets placed in the hands of a court or a State- or court-appointed official. More commonly, they will have the assets entrusted to a third-party depositary that they appoint or (in particular in cases where a manufacturing operation is involved) will appoint a representative to enter into the premises of the grantor in order to take possession of the encumbered assets. Where assets are already in the hands of a third party that is not acting for the secured creditor but that has previously been made aware of the security agreement, the secured creditor may simply give notice that the agreement has become enforceable and that the third party no longer has the right to retain possession of, to control or to dispose of the encumbered assets.

54. States usually consider the taking of possession of encumbered assets by secured creditors to be a significant step in the enforcement process and impose specific procedural requirements on creditors claiming possession. This means that, even though the secured creditor may have an automatic right to obtain possession, the manner for doing so is regulated. In general, States take one of three approaches in developing the procedural mechanisms by which secured creditors not in possession may take possession of encumbered assets. In some States, the secured creditor may only obtain possession by a court order, whether following an *ex parte* procedure or, more frequently, after a hearing. In other States, no judicial order is required, but the grantor must have authorized the creditor in the security agreement to obtain possession extra judicially and the creditor must give the grantor a prior notice (typically 10 or 20 days) of its intention to claim possession and to enforce. Finally, in some States the creditor is entitled to demand and to take possession without any recourse to a court and without the need to give the grantor prior notice of its intention to do so, provided that the grantor authorized the secured creditor to do so in the security agreement. Even in these States, however, the creditor does not have an absolute right to obtain possession extra judicially. There is always potential for the creditor to abuse its rights by threatening or intimidating the grantor, breaching the peace or claiming the encumbered assets under false pretences. Most of these States, therefore, prohibit any acts of the creditor to obtain possession that result in a disturbance of the public order. Should the grantor resist, a judicial order for possession would be required. States that permit extrajudicial creditor possession upon giving a 10- or 20-day prior notice typically also adopt this approach to possession and require a judicial order if a breach of the peace is threatened when the creditor seeks possession after the notice period has expired.

55. In States that impose a notice requirement on secured creditors as a precondition to obtaining possession, there is always a risk that a grantor in default may then seek to hide or transfer the encumbered assets before the secured creditor can take control of them. It may also be that the assets may be misused, may dissipate if they are not looked after or, depending on market conditions, may rapidly decline in value. To forestall these possibilities, most States provide that secured creditors may obtain expedited relief from a court or other relevant authority. Furthermore, in the special case where the encumbered assets are perishable or are otherwise likely to decline rapidly in value, whether or not secured creditors are required to give prior notice of their intention to enforce, many States permit the court to order the immediate sale of these assets.

56. The decision as to the formalities required to allow a secured creditor to obtain possession depends on the balance States strike between the protection of the rights of grantors and efficient enforcement to reduce costs. It also depends on a judgement as to the likelihood in practice of abuse by secured creditors or improper behaviour by grantors in possession. In order to reduce the cost of enforcement and minimize the chances that assets will be misused or dissipate in value, the *Guide* recommends that the secured creditor be authorized to obtain possession extra judicially. This recommendation applies only if: (a) the grantor has so consented in the security agreement; (b) notice of intention to take possession has been given to the grantor; and (c) the grantor does not object at the time possession is being sought (see recommendation 147). In addition, as noted above (see para. 46 above), the *Guide* recommends that notice of the creditor's intention to take possession and to dispose of the assets need not be given where assets are perishable or are otherwise likely to decline rapidly in value during the period between the giving of

notice and the time when the creditor may actually obtain possession of the assets (see recommendation 149). However, for the secured creditor to have this remedy, the grantor must have authorized extrajudicial possession in the security agreement and have no objection when possession is actually being sought (see recommendation 147).

(c) *Sale or other disposition of encumbered assets*

57. As a security right entitles the secured creditor to obtain the value from the sale of encumbered assets and to apply it to the secured obligation, States usually regulate in some detail the procedures by which the secured creditor may dispose of the assets. Requirements range from the less to the more formal. For example, even when extrajudicial enforcement is permitted, some States require disposition to be subject to the same public procedures used to enforce court judgements. Other States require secured creditors to obtain judicial approval of the proposed mode of disposition before proceeding. Still other States permit the secured creditor to control the disposition but prescribe uniform procedures for doing so (for example, rules relating to public auctions or a call for tenders). On occasion, States actually oblige the secured creditor to obtain the consent of the grantor as to the mode of disposition. Lastly, some States give the secured creditor a wide, unilateral discretion as to the mode of disposition, but subject this conduct to general standards (such as good faith and commercial reasonableness), the breach of which leads to the creditor's liability in compensatory damages.

58. Most commonly, the procedural safeguards by which States control the actions of secured creditors relate to the details of the notice that must be given to the grantor and third parties with a right in the encumbered assets. In principle, the types of detail required should be identical whether States opt for an approach requiring notification before or after possession. So, for example, States often require creditors to indicate the method of advertising a proposed disposition, the date, time and location of the sale, whether the sale will be by public auction or by tender, whether the assets will be sold individually, by lot or as a whole and whether the disposition includes leases, licences or associated permits where required. The objective should be to maximize the amount realized for the encumbered assets, while not jeopardizing the legitimate claims and defences of the grantor and other persons. This explains why even States that generally require detailed notices do not require them when the encumbered assets are to be sold on a recognized public market. In such cases, the market sets the value of the assets and there is no higher price to be obtained using some other mode of sale (see recommendation 149).

59. As an extrajudicial disposition of encumbered assets has the same finality as a court-supervised sale, most States not only impose relatively detailed rules as to the contents of the notice and the time that must elapse before the sale can take place, but also permit interested parties to object to the timing and manner of the proposed disposition. Typically, special expedited procedures are available so that objections may be quickly heard and dealt with (see recommendations 137 and 138). As a general rule, where the enforcing creditor has the greatest flexibility as to timing and method of disposition, the cost of enforcement is lowest, the enforcement is most expeditious and the proceeds received are highest. For these reasons, the *Guide* recommends flexibility for secured creditors and only the basic minimum of detail in the notice necessary to alert interested parties to the enforcement and the need to protect their interests should they wish (see recommendations 150

and 151). Since the purpose of the notice is to indicate the particular remedy being exercised, like the preliminary notice of default and possession, this notice must be understandable to the grantor. Hence, in line with article 16, paragraph 1, of the United Nations Assignment Convention, the *Guide* recommends that the notice should be in a language that can reasonably be expected to be understood by its recipients, though it is sufficient if the notice to the grantor is in the language of the security agreement (see recommendation 151, subparagraph (c)).

(d) *Allocation of proceeds of sale or other disposition*

60. One of the important features of secured transactions law is that it disrupts the normal rules for distributing the proceeds of disposition that apply as among unsecured creditors. After all, the object of the security is to obtain a priority in the distribution of these proceeds. If the enforcement of the security right has taken place judicially or in situations where a secured creditor has not taken over an enforcement process brought by a judgement creditor, the proceeds will be held by a public authority pending their distribution to the parties entitled to them. When the regime provides for a purge of rights (that is, the extinguishing of all property rights, including all security rights, in the assets), the most common allocation is to pay reasonable enforcement costs first and then the secured obligations in the order of their priority. Many States also provide for the payment of certain statutory claims after costs of enforcement but before payments to secured creditors. If the ordinary enforcement process does not provide for a purge of rights, secured creditors will not receive payment but will be able to assert their security rights against the purchaser.

61. Where a secured creditor enforces through an extrajudicial sale, States typically provide in their secured transactions law a series of rules relating to the proceeds of the sale. Often there are special rules dealing with the manner by which proceeds are to be held by the secured creditor pending distribution. These rules usually also prescribe if and when a secured creditor is responsible for distributing proceeds to some or all other creditors. Other creditors in such cases may include secured creditors with security rights in the encumbered assets with a lower priority ranking than that of the enforcing secured creditor. If the enforcement regime provides for a purge of rights, the enforcing creditor may also be required to distribute the proceeds to secured creditors with a higher priority ranking and to claimants asserting a statutory priority. Often, the secured creditor need take account of these other rights only if they are registered or have otherwise been made effective against third parties or if the secured creditor has been expressly notified of them (as is the case, for example, with statutory priority claims that need not be registered). Invariably States also provide that any surplus proceeds remaining after all claims have been satisfied are to be remitted to the grantor. This is also the approach recommended in the *Guide* (see recommendation 152).

62. In many cases, the appropriate distribution of the proceeds of realization may not be absolutely clear or may be the subject of a dispute among competing claimants. Most often this uncertainty or these disputes arise in connection with the distribution of a surplus. They can also arise, however, where another secured creditor claims priority over the enforcing creditor or where a competing claimant, such as a transferee, asserts its rights after a sale has taken place. To facilitate the resolution of all these

types of conflict, most States provide that the enforcing secured creditor may deposit the proceeds of disposition with a court or other authority. If the dispute involves the enforcing secured creditor's rights and the rights of competing claimants, States normally require the deposit of the entire proceeds pending resolution of the dispute. If, by contrast, the dispute is only among claimants with a lower priority, the enforcing secured creditor normally need only deposit the surplus after satisfying its own claim. To promote efficiency in enforcement, this is the approach recommended in the *Guide* (see recommendation 153).

63. The secured obligation is discharged only to the extent of the proceeds received from the sale of the encumbered assets. Normally, the secured creditor is then entitled to recover the amount of the deficiency from the debtor of the secured obligation. Unless the grantor has created a security right in other assets for the benefit of the creditor, the creditor's claim for the deficiency is an unsecured claim. Regardless of whether there is a deficiency or a surplus, some States provide that, when a secured creditor purchases the encumbered assets at an enforcement sale and later sells them at a profit, the amount received for the sale that exceeds the amount paid by the creditor and the costs of the further sale is required to be applied to the secured obligation. Generally, however, States do not attempt to trace the resale value obtained when a secured creditor disposes of encumbered assets that it has purchased. Unless the initial sale to the secured creditor can be shown to have been commercially unreasonable or conducted in bad faith, States consider the amount generated by that sale to be the final value received upon disposition of the encumbered assets.

64. As already mentioned (see paras. 57-59 above), instead of selling or otherwise disposing of the encumbered asset, a secured creditor may choose to lease or license it. Where this is the case, the proceeds of the lease or licence contract (including any payment made as a consequence of the exercise of an option to purchase the encumbered asset in the case of a lease) will be applied to the secured obligation. States take different approaches to determining how these proceeds will be applied to the secured obligation for the purpose of calculating any deficiency or surplus. Some States provide that the secured obligation will be reduced by the value of the lease or licence contract, or the value of the encumbered asset, at the time the lease or licence contract is entered into. Other States provide that the secured obligation is only reduced by the payments made under the lease or licence contract as they are received by the secured creditor. Still other States give the secured creditor the option of determining how the secured obligation will be reduced as long as the secured creditor acts in good faith and in a commercially reasonable manner. As the resolution of this issue involves basic considerations of other law, the *Guide* does not make a specific recommendation.

(e) Acquisition of the encumbered assets in satisfaction of the secured obligation

65. The underlying rationale for creating a security right is to enable the secured creditor to obtain the value of the encumbered asset and to apply the proceeds received to payment of the secured obligation. For this reason, in many States, a creditor's only recourse upon default is to seize the encumbered assets and sell them. In most States that so limit the secured creditor's remedies, the limitation applies even when the creditor is already in possession of the encumbered assets under a security agreement. That is, in these States it

is not possible for the parties to agree in advance that, should the grantor default, the secured creditor may keep the encumbered assets in satisfaction of the secured obligation. Similarly, in many of these States the secured creditor may not keep the encumbered assets in satisfaction of the secured obligation even if the grantor agrees after default has occurred. Moreover, even if the grantor and the secured creditor agree, after default, that the secured creditor may keep the encumbered assets, in these same States such arrangements are considered to be a contractual payment and have no effect on the rights of any other party with a right in the encumbered assets.

66. By contrast, in many States, the secured creditor is entitled to propose to the grantor that the secured creditor acquire the encumbered assets in full or partial satisfaction of the secured obligation. Where such an enforcement remedy is made available to secured creditors, States usually provide that any agreement that automatically vests ownership of the encumbered assets in the secured creditor upon default is unenforceable if entered into prior to default. However, the agreement is enforceable if made after default and according to the specific enforcement procedures designed to prevent creditor abuse. These States usually also provide that any informal private agreements entered into by grantors and secured creditors after default are enforceable, but only as contractual payment remedies that have no effect on third parties with rights in the encumbered assets. That is, in order for a secured creditor to acquire the encumbered assets under conditions that protect its rights against secured creditors and competing claimants with lower priority, it must follow the formal procedural steps for acquiring the encumbered assets in total or partial satisfaction of the secured obligation.

67. Where States expressly permit the secured creditor to propose to acquire the encumbered assets in satisfaction of the secured obligation after default (provided that the creditor has followed the required procedural steps) this does not mean that the grantor must accept the secured creditor's offer. The grantor may refuse to do so, with the consequence that the secured creditor will have to pursue one of its other remedies. The advantage of permitting these types of post-default agreement is that they can often lead to less expensive and more expeditious enforcement. The disadvantage is that there may be a risk of abuse by the secured creditor in cases where: (a) the encumbered assets have value in excess of the secured obligation; (b) the secured creditor has, even in the post-default situation, unusual power over the grantor; and (c) the secured creditor and the grantor come to an arrangement that unreasonably prejudices the rights of third persons with a right in the encumbered assets.

68. To guard against the potential for abusive or collusive behaviour by the secured creditor and the grantor, some States require not only the consent of the grantor to the acquisition of the encumbered assets by the secured creditor, but also that notice be given to third parties with rights in the encumbered assets. These third parties then have a right to object to the proposed agreement and may require the secured creditor to enforce the security by means of a sale. In addition, some States require the consent of a court under certain circumstances, such as where the grantor has paid a substantial portion of the secured obligation and the value of the encumbered assets greatly exceeds the outstanding obligation. Finally, some States require that a secured creditor that proposes to acquire encumbered assets in satisfaction of the secured obligation be required to provide an official and independent appraisal of the value of the encumbered assets before proceeding.

69. Whether States should impose any or all of these requirements, especially the requirement of prior judicial involvement, will depend on their assessment of the costs and benefits of each requirement. In line with the general objective of maximizing flexibility so as to obtain the highest possible value for encumbered assets at the point of enforcement, the *Guide* recommends that either the secured creditor or the grantor may propose to the other that the assets be taken in total or partial satisfaction of the secured obligation (see recommendations 156 and 159). If the grantor makes a proposal, the secured creditor may accept or decline the proposal. If the secured creditor makes a proposal on its own initiative, makes a proposal in response to an invitation from the grantor or accepts the grantor's own proposal, the secured creditor must give notice to the grantor, to any person with rights in the encumbered assets that has notified the enforcing creditor of its rights and to any secured creditor that was in possession of the assets at the time the enforcing creditor took possession (see recommendation 157, para. (a)). The reason for including the grantor in the list of recipients even when the grantor has invited the secured creditor to make a proposal is that the specific terms of the proposal may not be acceptable to the grantor. To ensure that all parties understand the full implications of the proposal, the *Guide* recommends that the notice indicate not only the assets to be taken in satisfaction, but also both the amount owed at the time the notice is sent and the amount of the obligation that is proposed to be satisfied by the acquisition (see recommendation 157, subparagraph (b)).

70. The assumption underlying these requirements is that obliging the secured creditor to indicate its own valuation of the encumbered assets is a more efficient and less costly mechanism for providing relevant information to interested parties than providing for an independent appraisal. It is also assumed that, once informed of the secured creditor's proposal, the grantor or third parties will be in a position to assess its reasonableness. This is the reason why the *Guide* further recommends that the grantor or third parties be given a right to object, within a reasonably short period of time, to the secured creditor's acquisition of the encumbered assets. The consequence of a timely written objection is that the secured creditor must abandon this remedy and exercise another of its remedies, such as an extrajudicial sale or other disposition (see recommendation 158, first sentence). Moreover, the *Guide* recommends that, in the case where the secured creditor's proposal is to acquire the encumbered assets only in partial satisfaction of the secured obligation, it is not sufficient that addressees of the notice fail to object in a timely fashion. Each must affirmatively consent to the proposal (see recommendation 158, second sentence). As in the case where the secured creditor proposes to dispose of the asset, in cases where the secured creditor proposes to take it in full or partial satisfaction of the secured obligation, the notice must be understandable to the grantor. Consistent with the approach recommended in the *Guide*, the notice should be in a language that can reasonably be expected to be understood by its recipients (see recommendation 151, subparagraph (c)).

(f) *Management and sale of a business*

71. In many circumstances, a secured creditor has security not just on specific assets of a grantor but on most or all of the assets of a business. In these situations, the highest enforcement value can often be obtained if the business is sold as a going concern. In order to be able to do so efficiently, secured creditors usually must be able to dispose of all the assets of the business, including immovable property, together. Moreover, in

such cases, States often prescribe special notice procedures for the sale and more strictly regulate the conditions under which the sale of a business as a going concern may take place.

72. Alternatively, in many cases where enforcement becomes necessary, it is not in the interest of the grantor or the secured creditor to dispose immediately of all the assets of a business, whether these are sold by category (such as inventory or equipment) or whether the business is sold as a whole. For this reason, some States permit secured creditors to take possession of business operations and manage the business for a certain period of time after default. Frequently, these States require that the notice of enforcement specifically indicate that, when taking possession of the encumbered assets, the creditor intends to wind down the business gradually. This is especially important for other creditors that otherwise may not know that a liquidation is taking place. Some States also prescribe special procedures for naming a manager, for operating the business, for alerting suppliers of the secured creditor's rights and for informing customers that what looks like an ordinary-course-of-business sale is in fact part of an enforcement process.

73. In this situation, once the inventory of the business has been effectively liquidated, the secured creditor typically will proceed to exercise one or more of its other remedies. In such cases, most States require the secured creditor to give a further notice to the grantor and other parties with a right in the remaining assets each time that it proposes to exercise another of its remedies, such as acquiring the assets in total or partial satisfaction of the secured obligation or, more commonly, selling them. Once such a notice is given, the regular enforcement procedures applicable to that recourse will apply. The *Guide* does not make a formal recommendation on whether a secured creditor should have the right to take over the management of a business for purposes of selling it. States interested in this remedy may have to weigh the benefits against the responsibilities associated with management of a business by a secured creditor and the impact of such a remedy on the rights of other creditors, secured or unsecured.

5. *Effects of enforcement*

(a) *Judicial and extrajudicial dispositions*

74. Most States provide that a secured creditor may enforce its security rights either by applying to a court or by following an extrajudicial process. When the secured creditor opts for a judicial or other officially administered process, the general legislation relating to enforcement of judgements will normally apply so as to determine both the rights of the grantor following the judicial sale and the rights acquired by the transferee. Since these procedural rules are integrated within the overall system of civil enforcement within a State, the *Guide* does not contain specific recommendations on judicial enforcement of security rights. Rather, to avoid interference with general rules of civil procedure governing proceedings relating to enforcement of judgements, the *Guide* leaves the matter to other law (see recommendation 160).

75. By contrast, where States permit extrajudicial enforcement, in order to make the enforcement regime as expeditious as possible States typically enact detailed rules that

determine the effect of enforcement on: (a) the relationship between the grantor and the secured creditor; (b) the rights of parties that may purchase the encumbered assets at an enforcement sale; and (c) the rights of other secured creditors to receive the proceeds generated by the sale of the encumbered assets. The primary purpose of an enforcement procedure is to generate value for the secured creditor that can be deployed to satisfy the unpaid secured obligation. In the most common situation, the secured creditor will acquire this value by selling the encumbered assets and applying the proceeds to the secured obligation. Should there be a surplus, the secured creditor must return it to the grantor or to any other person entitled to it. Moreover, as noted above, should there be a deficiency, most States provide that the secured creditor retains an ordinary contractual right to sue the grantor for the deficiency as an unsecured creditor. The details of how proceeds of disposition are normally allocated in these cases have already been discussed (see paras. 60-63 above).

76. As noted, however, sometimes the secured creditor will acquire the encumbered assets in satisfaction of the secured obligation (see paras. 65-70 above). Not all States adopt identical rules to govern the effects of this particular remedy. Usually, States provide that the creditor that acquires an asset in satisfaction may keep it, even where the value of the asset exceeds the amount of the secured obligation that is still owed. This means that, unlike the case of a sale, the secured creditor may keep a surplus. Concomitantly, many of these States provide that a secured creditor that acquires an asset in satisfaction of an obligation has no recourse for a deficiency against the grantor. The acquisition is deemed to be complete payment and therefore extinguishes the secured obligation. By contrast, however, other States permit creditors that have taken encumbered assets in satisfaction of a secured obligation to pursue their grantor for a deficiency. In these cases, it becomes necessary to establish the value of the assets being taken in satisfaction so that the amount of the deficiency may be calculated. Some States require the secured creditor to provide an independent accounting of the value of the assets it has taken, while other States merely require the secured creditor to indicate the value that it ascribes to these assets. In either case, as noted above, the grantor or other creditor may require the secured creditor to sell the asset instead. For reasons given in paragraph 65 above, the *Guide* recommends that secured creditors may propose to acquire the asset in total or partial satisfaction of the secured obligation, provided that they indicate the value they ascribe to it in the notice sent to the grantor and third parties (see recommendations 156 and 157).

(b) *Specific effects of extrajudicial disposition*

77. When a secured creditor enforces its security right by means of a sale of encumbered assets, there are different approaches to determining the effects of the sale on other parties. In some States, the sale (even when it is an extrajudicial sale) will extinguish all security rights in the encumbered assets (a circumstance sometimes referred to as a purge of the assets). Where this is the case, even secured creditors with a priority ranking higher than that of the enforcing secured creditor will lose their security rights and will only have a claim in the proceeds with a priority ranking equivalent to the ranking of their security rights in the original encumbered assets. Parties that purchase the assets will obtain a clear title and, it is presumed, will be willing to pay a premium to do so. In other States, the sale of assets by a creditor (whether it is managed by a judicial officer or it is a private sale by

the creditor) will only extinguish rights with a lower priority ranking than that of the enforcing secured creditor. Consequently, a secured creditor with a higher priority ranking will retain its security right in the encumbered assets. Purchasers at the sale will not obtain a clear title and will, consequently, discount the amount they offer for the assets being sold. The assumption is that normally either the highest ranking secured creditor will take over the enforcement proceedings (so that all security rights will be extinguished) or a lower ranking secured creditor will arrange to pay off the higher-ranking creditor so as to produce a clear title.

78. While either approach will usually produce a clear title, the second approach maximizes the flexibility of the enforcing secured creditor and the purchaser to reach an alternative arrangement in the event that the purchaser cannot finance the entire cost of the encumbered asset and, therefore, can purchase it for a discounted price because it is subject to a higher-ranking security right. To maximize flexibility and efficiency in enforcement, the *Guide* recommends adoption of the second approach with respect to extrajudicial dispositions (see recommendation 161, first sentence). Sometimes, the secured creditor may choose not to sell the encumbered asset, but rather may choose to lease or license it, applying the payments received on the lease or licence towards the satisfaction of its claim (see para. 63 above). In such cases also, most States provide that the lessee or licensee acquires the full benefit of the lease or licence for its entire term, except as against rights that have priority over those of the enforcing secured creditor. This is also the approach recommended in the *Guide* (see recommendation 162).

79. When a secured creditor acquires the encumbered assets in satisfaction of the secured obligation, States usually provide that the secured creditor acquires the assets as if they were transferred through an enforcement sale. While it is possible that States could provide that an acquisition of the encumbered assets in satisfaction of the secured obligation results in a purge of all rights in the assets, this would invariably lead secured creditors with a higher priority ranking than that of the enforcing secured creditor to take over the enforcement process. Therefore, most States provide that the rights of other competing claimants creditors are determined by their priority relative to the right of the enforcing creditor. Thus, for example, where a State permits a secured creditor to take an encumbered asset in satisfaction of the secured obligation, that creditor will acquire the asset subject to the rights of competing claimants with a higher priority ranking. Conversely, if there are competing claimants with lower priority, their rights normally will be extinguished upon acquisition of the encumbered assets by a secured creditor with higher priority. For the same reasons as those applicable to the remedy of extrajudicial sale, the *Guide* recommends that a secured creditor that acquires an asset in satisfaction takes it free of lower priority rights but subject to the rights of competing claimants with a higher priority (see recommendation 161, second sentence).

80. Sometimes a secured creditor may dispose of encumbered assets by sale, lease or license without following the procedures States impose to protect grantors and third parties with rights in the assets. It then becomes necessary to determine the effect of the disposition on the rights of the grantor and of the transferee, lessee or licensee. Some States provide that the sale is void. Other States provide that, if the transferee, lessee or licensee is acting in good faith, it will acquire the same rights as if the sale had been made in accordance with the rules governing extrajudicial disposition. This

is the approach recommended in the *Guide* (see recommendation 163). As for the grantor and other secured creditors, if they can demonstrate that the failure to follow the mandatory provisions governing extrajudicial disposition has resulted in prejudice to their rights, most States provide that the sale will not be set aside but that the grantor or other party may recover damages from the enforcing creditor (see recommendation 136). Normally, however, the amount received upon a non-conforming disposition will not be less, and may even be more, than the proceeds received through a conforming disposition. In such a case, of course, neither the grantor nor third parties will suffer any prejudice.

(c) *Finality*

81. Where enforcement takes place judicially, other law within a State will provide rules to govern the situations under which a judicial sale may be reopened. Some States also provide rules within their secured transactions law to address this same point. Normally, States provide for finality following extrajudicial enforcement. This means that, once the sale or acceptance in satisfaction has taken place according to the required enforcement procedures, it cannot be reopened. Unless fraud, bad faith or collusion between the seller and the buyer or between the grantor and the secured creditor can be proved, the sale is final.

6. *Enforcement of a security right in proceeds*

82. If the grantor sells the encumbered assets prior to enforcement, the proceeds of the sale take the place of the encumbered assets (see recommendation 80, subparagraph (a)). This is why many States provide that a security right in encumbered assets will automatically pass into the proceeds of their disposition. Other States either do not so provide or provide that the right passes into proceeds only if it does not continue in the encumbered assets following disposition, or require that the security agreement expressly indicate which proceeds will be covered by the security right. The *Guide* recommends that secured creditors always have the right to claim their security in proceeds of encumbered assets and proceeds of proceeds (see recommendations 19, 39 and 40). Moreover, unlike many States that limit the concept of proceeds to replacement assets, the *Guide* considers proceeds to include anything that is received on account of the encumbered asset, whether as proceeds of a disposition by the grantor or as any natural and civil fruits or revenues generated by the asset (see chapter II on the creation of a security right, paras. 72-78).

83. Generally, States do not enact separate rules governing the enforcement of security rights in proceeds. This means that enforcement against proceeds will follow whatever type of process is required in order to enforce a security right against the type of asset represented by the proceeds (for example, a tangible asset, a receivable, a negotiable instrument or a right to payment of funds credited to a bank account). It would create considerable confusion if some secured creditors could enforce security rights in proceeds according to the rules governing enforcement against the type of asset represented by the original encumbered assets while other secured creditors seeking to enforce security rights against those proceeds as original encumbered assets had to follow rules specifically applicable to the type of asset represented by the proceeds. So, for example, in the case

where proceeds are receivables generated by the sale of a tangible asset, it would be unworkable to provide that a creditor that took a security right in the receivables as original encumbered assets would have to follow enforcement rules governing receivables, but a creditor that took a security right in the tangible asset could enforce its rights in the proceeds according to the enforcement rules governing tangible assets.

84. By not recommending special enforcement rules applicable to proceeds, the *Guide* implicitly recommends that the general enforcement rules apply also to the enforcement of security rights in proceeds. This means notably that, if the proceeds are tangible assets, the enforcement rules governing tangible assets would apply. If, by contrast, the proceeds are receivables or other specific assets such as those mentioned in section B below, the *Guide's* asset-specific enforcement recommendations governing security rights taken in those types of asset as original encumbered assets would apply to enforcement against the proceeds.

7. *Intersection of movable and immovable property enforcement regimes*

85. Frequently, the characterization of tangible assets as movable or immovable property will change over time, as movable assets become immovable property. For example, construction materials may become fully incorporated into a building or shrubs, trees, seeds and manure may be planted or tilled into soil, thereby turning into immovable property. Sometimes, the movable asset may be an attachment and not fully incorporated into immovable property. Examples would include a lift, a furnace or an attached counter or display case. In all of these cases, a security right in the movable assets may have been made effective against third parties prior to attachment to or incorporation into the immovable property. The converse situation can also arise. A creditor may seek to take a security right in an asset that is currently immovable property, but is destined to become movable. This situation could arise, for example, in connection with crops, products of mines and quarries and hydrocarbons.

86. States have enacted many different rules to govern these various situations. A primary concern is to establish the rights of creditors that seek to enforce security rights in movable assets where movable and immovable property enforcement regimes may intersect. Most often, these enforcement regimes depend on the characterization given to the assets. Thus, for example, many States permit the creation of a security right under secured transactions law in movable assets that, while still a part of immovable property, are destined to become movable. In these cases, the effectiveness of the security right even between the parties is postponed until detachment. No enforcement of the security right can take place until the asset becomes movable. Conversely, no enforcement of an encumbrance on immovable property may be taken against assets that have become movable. Although the *Guide* makes no specific recommendation on this question, because the enforcement regime it recommends presupposes the separate existence of tangible assets as movable assets, the enforcement regime for immovable property will not apply to the enforcement of security rights in a movable asset that has been detached from immovable property.

87. More difficult enforcement questions arise when tangible assets are attached to or incorporated into immovable property. Many States distinguish among construction

materials, other movable assets that lose their identity when incorporated into immovable property (such as fertilizer or seeds) and attachments that retain their identity as movable assets. Some States provide that security rights in movable assets that lose their identity may only be preserved if they are made effective against third parties by registration in the immovable property registry, but that security rights in attachments made effective against third parties prior to the attachment retain their effectiveness without further registration. In these States, enforcement against the former kind of assets would always be governed by the rules relating to enforcement of encumbrances on immovable property. Where, by contrast, the movable assets become an attachment, these States usually enact special rules to govern not only the preservation of the secured creditor's rights, but also the preservation of the rights of creditors with rights in the immovable property.

88. The *Guide* follows the general pattern that many States have adopted for resolving conflicts between secured creditors and competing claimants with competing rights in attachments. Where tangible assets lose their identity through incorporation into immovable property, any security right in the movable assets is extinguished. Where, however, the encumbered asset becomes an attachment, the security right in that asset continues and its effectiveness against third parties is automatically preserved. The secured creditor may also ensure third-party effectiveness by registration of the security right in the immovable property registry (see recommendations 38 and 43). The enforcement rights of the secured creditor as against the attachment and in relation to secured creditors that may have security rights in the immovable property will then depend on the relative priority of the competing rights (see recommendations 87 and 88). If the secured creditor with rights in the attachment has priority, it may detach the assets and enforce its security right as a security right in the movable assets. However, in this case, the right of the enforcing secured creditor is subject to the right of another secured creditor or other interested party with lower priority than the enforcing secured creditor to pay the value of the attachment and, thereby, to prevent the detachment. If, however, detachment of an attachment to immovable property (such as a lift from a building) damages the immovable property otherwise than simply by diminishing its value, the enforcing secured creditor has to compensate persons with rights in the immovable property. If another creditor with a security right in the immovable property has priority, the secured creditor can enforce its rights only under the regime governing encumbrances on immovable property, provided that it has maintained effectiveness against third parties by registering in the immovable property registry (see recommendations 164, subparagraph (a), and 165).

89. The enforcement of security rights in attachments to immovable property is further complicated in cases where the secured creditor has taken an encumbrance on the immovable property and a security right in the movable asset that has become an attachment to the immovable property. Most States enable the creditor in such cases to enforce the security in a variety of ways. The creditor may enforce the security right in the attachment separately and also enforce the encumbrance against the rest of the immovable property. Alternatively, the secured creditor may enforce the encumbrance against the entire immovable property, including the attachment. In the former case, the secured creditor would have to have priority over all rights in the immovable property (see recommendation 165). In the latter case, the rights of the creditor would be determined by the priority regime governing immovable property (see recommendation 164, subparagraph (b)).

8. *Enforcement of a security right in an attachment to movable assets, a mass or a product*

90. Many types of tangible asset in which a security right has been created are destined to be attached to other tangible assets, to be manufactured into a product or to be commingled with other tangible assets into a mass. Some States deal with security rights in such cases by determining whether ownership in the attachment, manufactured product or mass has passed to the owner of the other tangible assets. For example, if ownership of the encumbered asset passes to the owner of the other tangible assets to which the encumbered asset is attached or into which it is commingled, the security right in the encumbered asset is extinguished. Other States permit continued third-party effectiveness of security rights in tangible assets that are attachments, manufactured products or commingled assets, without regard to whether ownership changes as a result of the attachment or commingling. This is the approach adopted by the *Guide* (see recommendations 41-44). Where States provide for a continuation of the security right following attachment or commingling, they normally also apply the general rules to enforcement against this type of asset. If the attachment or commingling concerns tangible assets such as automobile engines, manufactured fibreglass products, commingled inventories of clothing, grain in a silo or oil in a tank, enforcement follows the regime governing tangible assets. If the commingling involves intangible assets such as receivables or money in an account, enforcement follows the general regime governing these types of asset. The assumption, also adopted by the *Guide*, is that it would create unnecessary confusion if an enforcement regime other than that generally applicable to these types of asset were to be enacted.

91. With respect to the enforcement of a security right in an attachment to a movable asset, most States adopt rules similar to those that apply to a security right in an attachment to immovable property. A secured creditor with a lower priority ranking than that of the enforcing secured creditor may pay off the claim of the enforcing secured creditor, a secured creditor with a higher priority ranking may take over the enforcement process and the enforcing secured creditor is liable for any damage caused by the act of removal of the attachment other than a diminution of value resulting from the detachment. However, there is one difference between the treatment of a security right in an attachment to immovable property and a security right in an attachment to movable assets. In the former case (attachments to immovable property), the secured creditor must have priority as against competing rights in the immovable property in order to enforce its security right in the attachment (see recommendation 165). In the latter case (attachments to movable assets), enforcement may take place regardless of the relative priority position of the enforcing creditor (see recommendation 166).

92. In the case of products or masses, more than one secured creditor may have rights in the end product and the component assets. If the encumbered assets can be subdivided, as is the case with masses, the secured creditor with an enforceable security right against only a part of the assets should be able to segregate the part in which it has a security right and dispose of that part in accordance with the general rules governing enforcement. Thus, for example, if a secured creditor has a security right in one third of the oil in a tank, it may enforce its security against that one third of the commingled mass. If the encumbered assets cannot be separated, as is the case with products such as most manufactured inventory and equipment, the whole product may have to be sold and the rights of competing secured creditors with rights in other parts of the

commingled assets will be determined by the *Guide's* recommendations relating to priority (see recommendations 90-92).

B. Asset-specific remarks

1. General

93. The basic principles governing enforcement of security rights reviewed in section A above could theoretically apply whatever the type of encumbered asset. Nonetheless, they primarily envision certain types of tangible asset, such as inventory, equipment and consumer goods. For this reason, these rules do not easily apply either to the enforcement of security rights in intangible assets, such as receivables and various payment rights (such as a right to payment of funds credited to a bank account, a right to receive the proceeds under an independent undertaking or a payment right arising from a negotiable instrument) and rights to possession arising from a negotiable document. Consequently, many States have enacted special rules governing enforcement against these types of encumbered asset. These rules include, *inter alia*, provisions giving the secured creditor the right to collect from the person obligated on a receivable or negotiable instrument and requiring that person to make payments directly to the secured creditor. Moreover, in many of these cases, secured transactions law accommodates and in part defers to the specialized law and commercial practices governing bank accounts, negotiable instruments, negotiable documents and independent undertakings.

2. Enforcement of a security right in a receivable

94. When a security right is taken in a receivable, the encumbered asset is the grantor's right to receive payment from the debtor of the receivable. It would be logically possible to require the assignee to enforce the assignment of the receivable by either selling it or collecting it or keeping the proceeds of its payment in satisfaction of the secured obligation. Yet selling the receivable would be a cumbersome and inefficient way of obtaining the economic value of an asset that has, of itself, a determinate monetary value. This is why most States that permit creditors to take a security right in receivables and other claims enable the assignee to collect payment directly from the debtor of the receivable once the assignor is in default. The primary concerns are two. The first concern is that the assignor knows that the assignee is enforcing (either after default or, with the agreement of the assignor, before default). The second concern is that the debtor of the receivable knows that it must thereafter make payments to the assignee.

95. In chapter VI on the rights and obligations of the parties to a security agreement, the *Guide* discusses the relationship between the assignor, the assignee and the debtor of the receivable. The issues discussed include, for example, the right of the assignee to inform the debtor of the receivable to make payments directly to the assignee following the assignor's default (see recommendations 114-116). The *Guide* also provides, in chapter VII on the rights and obligations of third-party obligors, *inter alia*, that the debtor of the receivable is protected against having to pay twice by the notification and payment instruction given by the assignee or the assignor (see recommendations 117-123).

96. Many States take the position that the assignee's primary enforcement right is simply to collect the receivable. Assuming that it has followed the steps required to make its rights effective against the debtor of the receivable, the assignee will simply collect payment, applying the proceeds to reducing the assignor's obligation. The rationale is that the rights of the assignor and third parties will be protected simply by the normal application of the money received to a reduction of the secured obligation. Consistent with the approach taken by these States, the *Guide* recommends that no further steps to achieve enforcement need be taken (see recommendation 168).

97. Nonetheless, there may be cases where the assignee may wish to appropriate the entire present value of a receivable that may be spread out in instalments due over several months. The assignee may, therefore, after notifying the debtor of the receivable that it will be collecting the account, sell or transfer the receivable to a third person. To protect the assignor's rights in such cases, many States provide that the assignee may not keep any excess above the amount owed by the assignor on its secured obligation, a position the *Guide* adopts not only in relation to such dispositions of receivables but also in relation to the ordinary collection of receivables (see recommendation 116, subparagraph (b)). Moreover, consistent with the general principles applicable to enforcement, the assignee must act in good faith and in a commercially reasonable manner in disposing of the receivable (see recommendation 131).

98. In some cases, the receivable itself will be secured by some other personal or property right, such as a personal guarantee by a third party or a security right in movable assets of the debtor of the receivable. Many States provide for an automatic right of the assignee to enforce these other rights should the debtor of the receivable default in paying the receivable as it falls due. This outcome is a normal consequence of a security right (the accessory follows the principal). The *Guide* adopts a similar recommendation concerning guarantees of the third-party obligor's obligation to pay. The secured creditor may enforce these guarantees according to the law normally applicable to enforcement of that type of guarantee or that type of asset (see recommendation 169). In most States, the same principle also applies to personal and property rights that guarantee or secure other payment rights, such as the right to receive the proceeds under an independent undertaking. The *Guide* recommends this approach (see recommendation 25).

3. *Enforcement in the case of an outright transfer of a receivable*

99. The *Guide* applies to outright transfers of receivables and security rights in receivables (see recommendation 3). However, in an outright transfer, the assignor has generally transferred all of its rights in the receivable. Thus, the assignor has no continuing right in the receivable and no interest in the method of collection or other disposition of the receivable. Accordingly, the concerns addressed in the present chapter on enforcement are relevant to the outright transfer of a receivable only when the assignee has some recourse to the assignor for the non-collection of the receivables. That is, it is only where the assignor may ultimately be liable to the assignee that it has an interest in the method of collection or other disposition of the receivable (see recommendation 167).

100. Recourse to the assignor for the non-collection of receivables that have been the subject of an outright transfer usually arises when the assignor has guaranteed, in full or in part, the payment of the receivables by the debtor of the receivables. Recourse may also arise from other functionally equivalent arrangements, such as when: (a) the assignor agrees to repurchase a receivable sold to the assignee if the debtor of the receivable fails to pay; or (b) the assignor merely agrees to pay any deficiency between the purchase price for the bulk sale of receivables and the actual collection of those receivables.

101. There may be many reasons why a debtor of a receivable does not pay an obligation as it becomes due. For example, a debtor of a receivable may refuse to pay for tangible assets or services because of their poor quality or because the assignor failed to comply with the debtor's specifications for the assets being sold or services being provided. However, these refusals to pay are typically not considered to be examples of non-collection that would give rise to recourse against the assignor for non-collection. Recourse against the assignor for non-collection, as the term is used here, refers only to recourse arising from the failure of a debtor of a receivable to pay for credit reasons (that is, its financial inability to pay). Where non-payment arises for credit reasons and the assignee has recourse against the assignor, the mandatory general standard of conduct in the context of enforcement (see recommendations 131 and 132) and the normal rules for collection of receivables and enforcement of a security right would apply (see recommendation 167).

4. *Enforcement of a security right in a negotiable instrument*

102. In many States, it is possible to acquire a security right in a negotiable instrument, whether third-party effectiveness is achieved by taking possession of it or by registering a notice in the general security rights registry (see recommendations 32 and 37). Generally, even where there is a security right in the instrument, States defer to law governing negotiable instruments (a term that may be broader than the term "negotiable instrument law"; see Introduction, section B, Terminology and interpretation, para. 19) in determining the rights of persons obligated on the negotiable instrument and other persons claiming rights in the negotiable instrument (see recommendation 124 and chapter VII on the rights and obligations of third-party obligors, paras. 27-31). These rights might include, for example: (a) the right of the person obligated on the negotiable instrument to refuse to pay anyone other than a holder or other person entitled to enforce the instrument under law governing negotiable instruments; and (b) the right of the person obligated on the instrument to raise certain defences to that obligation.

103. Where security is taken in a negotiable instrument, secured creditors will normally have possession of the instrument. Upon default of the grantor, many States permit a secured creditor to enforce its security right by collecting or otherwise enforcing the instrument. This would include, for example, presenting it for payment or, if default occurs before maturity, even selling it to a third party and using the proceeds to pay the grantor's obligation. The rationale is that it would compromise the negotiability of the instrument if the secured creditor were obliged to go through the formalities required to exercise either the remedy of sale in disposition or taking the instrument in satisfaction of the

secured obligation. Consistent with such practices, the *Guide* does not recommend that any further post-default formalities be imposed on secured creditors enforcing rights in negotiable instruments (see recommendation 170).

104. As with receivables, it may be that the negotiable instrument is itself secured by some other personal or property right. Many States provide for an automatic right of the secured creditor to enforce these other rights should the person obligated under the negotiable instrument fail to pay upon presentment. The *Guide* recommends such an approach to enforcement of personal or property rights relating to the payment of a negotiable instrument (see recommendation 171).

5. *Enforcement of a security right in a right to payment of funds credited to a bank account*

105. Many States envision the possibility of creating a security right in a right to payment of funds credited to a bank account. In a bank account agreement, the bank is usually considered to be the debtor of the depositor and is obliged to pay the depositor all or a portion of the amount on deposit when requested. As banking law is closely tied to highly developed commercial practices, the *Guide* recommends deference to banking law and also provides additional safeguards for banks whose depositors may have granted security rights in their rights to payment of funds credited to a bank account (see recommendations 32, 49, 103, 104, 125 and 126). For example, it recommends that, even if a depositor has concluded a security agreement with a creditor, the depositary bank has: (a) the same rights and obligations in relation to its depositor; (b) the same rights of set-off; (c) no obligation to pay any person other than the person that has control of the account; and (d) no obligation to respond to any requests for information (see recommendations 125 and 126).

106. If the encumbered asset is a right to payment of funds credited to a bank account, in many States a secured creditor may collect or otherwise enforce its right to payment of the funds after default or even before default if so agreed with the grantor. Enforcement would normally occur by the secured creditor directing the bank to transfer the funds to its own account or otherwise withdrawing the sums credited to the account. The rationale for this rule is that the encumbered asset is the right to receive payment of the funds credited to the bank account and that it would be inefficient if the secured creditor were required to enforce its security right by selling the right to obtain payment or by taking that right in satisfaction of the secured obligation. Consistent with the objective of enhancing flexibility and efficiency in enforcement, the *Guide* recommends that creditors enforcing a security right in a right to payment of funds credited to a bank account may do so by collecting the money in the account (see recommendation 173).

107. Sometimes, States require the secured creditor to obtain a court order prior to enforcement of a security right in a right to payment of funds credited to a bank account. Such a requirement is understandable in situations where the secured creditor may have obtained third-party effectiveness through registration in the general security rights registry. The objective is to protect banks against having to make determinations as to the entitlement of enforcing creditors to obtain payment. However, where the bank is aware

of the security right because it has entered into a control agreement with the secured creditor, requiring a court order would be an unnecessary formality. For this reason, the *Guide* recommends that, where a control agreement has been entered into, the secured creditor need not obtain a court order to commence enforcement (see recommendation 174). Conversely, where no such agreement has been entered into, the *Guide* recommends that a court order be required, unless the bank specifically consents to collection by the secured creditor (see recommendation 175).

108. In many cases, the secured creditor will, in fact, be the depositary bank itself. Here, a formal enforcement process involving a specific act of collection and appropriation of the funds to repayment of the secured obligation would be superfluous. Upon default, a depositary bank acting as a secured creditor normally will deploy its right of set-off to apply the funds in the account directly to payment of the secured obligation in default. In keeping with this practice, the *Guide* recommends that enforcement of the depositary bank's right of set-off not be affected by any security rights that the bank may have in the right to payment of funds in that account (see recommendation 125, subparagraph (b)).

6. *Enforcement of a security right in a right to receive the proceeds under an independent undertaking*

109. Some States permit persons that have the right to demand payment (to "draw") under an independent undertaking to grant security in the right to receive the proceeds of that right to draw. The *Guide* recommends that security rights may be created in the right to receive such proceeds, subject to a series of rules governing the obligations between the guarantor/issuer, confirmer or nominated person and the secured creditor (see recommendations 27, 48 and 50). As the law and commercial practices governing independent undertakings are quite specialized, the *Guide* recommends adoption of a number of rules meant to reflect existing law and practice (see recommendations 127-129). Thus, for example, where the security right is automatically created, no separate act of transfer by the grantor should be necessary for the secured creditor to enforce a security right in a right to receive the proceeds under an independent undertaking.

110. The general practice of States is to permit a secured creditor whose security right is in the right to receive the proceeds under an independent undertaking to collect or otherwise enforce its right to payment of the proceeds after default, or even before default if so agreed with the grantor. However, enforcement does not permit the secured creditor to demand payment from the guarantor/issuer, confirmer or nominated person (see recommendation 27). Rather, enforcement would normally occur when the secured creditor indicates to the guarantor/issuer, confirmer or other nominated person that it is entitled to be paid whatever proceeds are otherwise due to the grantor. The rationale for this approach is that the guarantor/issuer, confirmer or other nominated person cannot be obligated towards anyone other than the beneficiary, and only the beneficiary may request payment of the independent undertaking. The *Guide* follows the practice relating to independent undertakings. It recommends that the enforcement of the security right be limited to collecting the proceeds once they have been paid and does not extend to the right to draw (see recommendation 176).

7. *Enforcement of a security right in a negotiable document or tangible assets covered by a negotiable document*

111. A number of States permit grantors to create a security right in a negotiable document. The *Guide* recommends a similar practice (see recommendations 2, subparagraph (a), and 28). The negotiable document itself represents the tangible assets covered by the document that are described in it and permits the holder of the document to claim those assets from the issuer of the document. Normally, secured creditors will enforce their security right by presenting the document to the issuer and claiming the assets. Special rules may, however, apply in order to preserve the rights of certain persons under the law governing negotiable documents, and the *Guide* defers to that law (see recommendation 130).

112. As between the grantor and the secured creditor, enforcement will occur when the secured creditor presents the document to the issuer. At this point, the secured creditor will obtain possession of the tangible assets and enforcement of the security right will then be subject to the normal principles recommended for the enforcement of security rights in tangible assets covered by a negotiable document (see recommendation 177). This presentation of the document to the issuer may, depending on the agreement between the parties, occur either upon default or prior to default with the grantor's permission. In addition, again depending on the agreement between the parties, either upon default or prior to default with the grantor's permission, the secured creditor may dispose of the document, in accordance with the general recommendation of the *Guide* relating to enforcement, without presenting it to the issuer. This must be done in good faith and in a commercially reasonable manner and the price obtained for the sale of the document will be applied to satisfaction of the secured obligation.

C. Recommendations 131-177

Purpose

The purpose of provisions on enforcement of security rights is to provide:

- (a) Clear, simple and efficient methods for the enforcement of security rights after debtor default;
- (b) Methods designed to maximize the net amount realized from the encumbered assets, for the benefit of the grantor, the debtor or any other person that owes payment of the secured obligation, the secured creditor and other creditors with a right in the encumbered assets; and
- (c) Expedient judicial and, subject to appropriate safeguards, non-judicial methods for the secured creditor to exercise its rights.

1. General recommendations

General standard of conduct in the context of enforcement

131. The law should provide that a person must enforce its rights and perform its obligations under the provisions on enforcement in good faith and in a commercially reasonable manner.

Limitations on party autonomy

132. The law should provide that the general standard of conduct provided in recommendation 131 cannot be waived unilaterally or varied by agreement at any time.

133. The law should provide that, subject to recommendation 132, the grantor and any other person that owes payment or other performance of the secured obligation may waive unilaterally or vary by agreement any of its rights under the provisions on enforcement, but only after default.

134. The law should provide that, subject to recommendation 132, the secured creditor may waive unilaterally or vary by agreement any of its rights under the provisions on enforcement.

135. The law should provide that a variation of rights by agreement may not adversely affect the rights of any person not a party to the agreement. A person challenging the effectiveness of the agreement on the ground that it is inconsistent with recommendation 132, 133 or 134 has the burden of proof.

Liability

136. The law should provide that, if a person fails to comply with its obligations under the provisions on enforcement, it is liable for damages caused by such failure.

Judicial or other relief for non-compliance

137. The law should provide that the debtor, the grantor or any other interested person (for example, a secured creditor with a lower priority ranking than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered assets) is entitled at any time to apply to a court or other authority for relief from the secured creditor's failure to comply with its obligations under the provisions on enforcement.

Expeditious judicial proceedings

138. The law should provide for expeditious proceedings to accommodate situations where the secured creditor, the grantor or any other person that owes performance of the secured obligation, or claims to have a right in an encumbered asset, applies to a court or other authority with respect to the exercise of post-default rights.

Post-default rights of the grantor

139. The law should provide that, after default, the grantor is entitled to exercise one or more of the following rights:

(a) Pay in full the secured obligation and obtain a release from the security right of all encumbered assets, as provided in recommendation 140;

(b) Apply to a court or other authority for relief if the secured creditor is not complying with its obligations under the provisions of this law, as provided in recommendation 137;

(c) Propose to the secured creditor, or reject the proposal of the secured creditor, that the secured creditor acquire an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 158 and 159; and

(d) Exercise any other right provided in the security agreement or any law.

Extinction of the security right after full satisfaction of the secured obligation

140. The law should provide that the debtor, the grantor or any other interested person (for example, a secured creditor whose security right has lower priority than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered asset) is entitled to satisfy the secured obligation in full, including payment of the costs of enforcement up to the time of full satisfaction. This right may be exercised until the earlier of the disposition, acquisition or collection of an encumbered asset by the secured creditor or the conclusion of an agreement by the secured creditor to dispose of the encumbered asset. If all commitments to extend credit have terminated, full satisfaction of the secured obligation extinguishes the security right in all encumbered assets, subject to any rights of subrogation in favour of the person satisfying the secured obligation.

Post-default rights of the secured creditor

141. The law should provide that, after default, the secured creditor is entitled to exercise one or more of the following rights with respect to an encumbered asset:

(a) Obtain possession of a tangible encumbered asset, as provided in recommendations 146 and 147;

(b) Sell or otherwise dispose of, lease or license an encumbered asset, as provided in recommendations 148-155;

(c) Propose that the secured creditor acquire an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 156-158;

(d) Enforce its security right in an attachment, as provided in recommendations 165 and 166;

(e) Collect on or otherwise enforce a security right in an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or right to receive the proceeds under an independent undertaking, as provided in recommendations 167-176;

(f) Enforce rights under a negotiable document, as provided in recommendation 177; and

(g) Exercise any other right provided in the security agreement (except to the extent inconsistent with the provisions of this law) or any law.

Judicial and extrajudicial methods of exercising post-default rights

142. The law should provide that, after default, the secured creditor may exercise its rights provided in recommendation 141 either by applying to a court or other authority, or without application to a court or other authority. Extrajudicial exercise of the secured creditor's rights is subject to the general standard of conduct provided in recommendation 131 and the requirements provided in recommendations 147-155 with respect to extrajudicial obtaining of possession and disposition of an encumbered asset.

Cumulative post-default rights

143. The law should provide that the exercise of one post-default right does not prevent the exercise of another right, except to the extent that the exercise of one right has made the exercise of another right impossible.

Post-default rights with respect to the secured obligation

144. The law should provide that the exercise of a post-default right with respect to an encumbered asset does not prevent the exercise of a post-default right with respect to the obligation secured by that asset, and vice versa.

Right of higher-ranking secured creditor to take over enforcement

145. The law should provide that, if a secured creditor has commenced enforcement by taking any of the actions described in the provisions on enforcement or a judgement creditor has taken the steps referred to in recommendation 84 (chapter V on the priority of a security right) a secured creditor whose security right has priority as against that of the enforcing secured creditor or the enforcing judgement creditor is entitled to take over the enforcement process at any time before the earlier of the final disposition or acquisition or collection of an encumbered asset or the conclusion of an agreement by the enforcing secured creditor to dispose of the encumbered asset. The right to take over enforcement includes the right to enforce by any method available under the recommendations in this chapter.

Secured creditor's right to possession of an encumbered asset

146. The law should provide that after default the secured creditor is entitled to possession of a tangible encumbered asset.

Extrajudicial obtaining of possession of an encumbered asset

147. The law should provide that the secured creditor may elect to obtain possession of a tangible encumbered asset without applying to a court or other authority only if:

(a) The grantor has consented in the security agreement to the secured creditor obtaining possession without applying to a court or other authority;

(b) The secured creditor has given the grantor and any person in possession of the encumbered asset notice of default and of the secured creditor's intent to obtain possession without applying to a court or other authority; and

(c) At the time the secured creditor seeks to obtain possession of the encumbered asset the grantor and any person in possession of the encumbered asset does not object.

Extrajudicial disposition of an encumbered asset

148. The law should provide that, after default, a secured creditor is entitled, without applying to a court or other authority, to sell or otherwise dispose of, lease or license an encumbered asset to the extent of the grantor's rights in the encumbered asset. Subject to the standard of conduct provided in recommendation 131, a secured creditor that elects to exercise this right may select the method, manner, time, place and other aspects of the disposition, lease or licence.

Advance notice of extrajudicial disposition of an encumbered asset

149. The law should provide that, after default, the secured creditor must give notice of its intention to sell or otherwise dispose of, lease or licence an encumbered asset without applying to a court or other authority. The notice need not be given if the encumbered asset is perishable, may decline in value speedily or is of a kind sold on a recognized market.

150. The law should provide rules ensuring that the notice referred to in recommendation 149 can be given in an efficient, timely and reliable way so as to protect the grantor or other interested parties, while, at the same time, avoiding having a negative effect on the secured creditor's remedies and the potential net realization value of the encumbered assets.

151. With respect to the notice referred to in recommendation 149, the law should:

(a) Provide that the notice must be given to:

(i) The grantor, the debtor and any other person that owes performance of the secured obligation;

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days before the sending of the notice by the secured creditor to the grantor, notifies in writing the secured creditor of those rights;

(iii) Any other secured creditor that, more than [a short period of time to be specified] days before the notice is sent to the grantor, registered a notice with respect to a security right in the encumbered asset that is indexed under the identifier of the grantor; and

(iv) Any other secured creditor that was in possession of the encumbered asset at the time when the enforcing secured creditor took possession of the asset;

(b) State the manner in which the notice must be given, its timing and its minimum contents, including whether the notice must contain an accounting of the amount then owed and a reference to the right of the debtor or the grantor to obtain the release of the encumbered assets from the security right as provided in recommendation 140; and

(c) Provide that the notice must be in a language that is reasonably expected to inform its recipients about its contents. It is sufficient if the notice to the grantor is in the language of the security agreement being enforced.

Distribution of proceeds of disposition of an encumbered asset

152. The law should provide that, in the case of extrajudicial disposition of an encumbered asset, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. Except as provided in recommendation 153, the enforcing secured creditor must pay any surplus remaining to any subordinate competing claimant that, prior to any distribution of the surplus, notified the enforcing secured creditor of the subordinate competing claimant's claim, to the extent of the amount of that claim. The balance remaining, if any, must be remitted to the grantor.

153. The law should also provide that, in the case of extrajudicial disposition of an encumbered asset, whether or not there is any dispute as to the entitlement of any competing claimant or as to the priority of payment, the enforcing secured creditor may, in accordance with generally applicable procedural rules, pay the surplus to a competent judicial or other authority or to a public deposit fund for distribution. The surplus should be distributed in accordance with the provisions of this law on priority.

154. The law should provide that distribution of the proceeds realized by a judicial disposition or other officially administered enforcement process is to be made pursuant to the general rules of the State governing execution proceedings, but in accordance with the provisions of this law on priority.

155. The law should provide that the debtor and any other person that owes payment of the secured obligation remain liable for any shortfall owing after application of the net proceeds of enforcement to the secured obligation.

Acquisition of an encumbered asset in satisfaction of the secured obligation

156. The law should provide that, after default, the secured creditor may propose in writing to acquire one or more of the encumbered assets in total or partial satisfaction of the secured obligation.

157. With respect to the proposal referred to in recommendation 156, the law should:

(a) Provide that the proposal must be sent to:

(i) The grantor, the debtor and any other person that owes payment or other performance of the secured obligation (for example, a guarantor);

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days before the proposal is sent by the secured creditor to the grantor, has notified in writing the secured creditor of those rights;

(iii) Any other secured creditor that, more than [a short period of time to be specified] days before the proposal is sent by the secured creditor to the grantor, registered a notice with respect to a security right in the encumbered asset indexed under the identifier of the grantor; and

(iv) Any other secured creditor that was in possession of the encumbered asset at the time the secured creditor took possession; and

(b) Provide that the proposal must specify the amount owed as of the date the proposal is sent and the amount of the obligation that is proposed to be satisfied by acquiring the encumbered asset.

158. The law should provide that the secured creditor may acquire the encumbered asset, as provided in recommendation 156, unless the secured creditor receives an objection in writing from any person entitled to receive a proposal under recommendation 157 within [a short period of time to be specified] days after the proposal is sent. In the case of a proposal for the acquisition of the encumbered asset in partial satisfaction of the secured obligation, affirmative consent by each addressee of the proposal is necessary.

159. The law should provide that the grantor may make a proposal such as that referred to in recommendation 156 and if the secured creditor accepts it, the secured creditor must proceed as provided in recommendations 157 and 158.

Rights acquired through judicial disposition

160. The law should provide that, if a secured creditor disposes of an encumbered asset through a judicial or other officially administered process, the rights acquired by the transferee are determined by the general rules of the State governing execution proceedings.

Rights acquired through extrajudicial disposition

161. The law should provide that, if a secured creditor sells or otherwise disposes of an encumbered asset without applying to a court or other authority, in accordance with the law, a person that acquires the grantor's right in the asset takes the asset subject to rights that have priority as against the security right of the enforcing secured creditor, but free of rights of the enforcing secured creditor and any competing claimant whose right has a lower priority than that of the enforcing secured creditor. The same rule applies to rights in an encumbered asset acquired by a secured creditor that has acquired the asset in total or partial satisfaction of the secured obligation.

162. The law should provide that, if a secured creditor leases or licenses an encumbered asset without applying to a court or other authority, in accordance with the law, a lessee or licensee is entitled to the benefit of the lease or licence during its term, except as against rights that have priority over the right of the enforcing secured creditor.

163. The law should provide that, if the secured creditor sells or otherwise disposes of, leases or licenses the encumbered asset not in accordance with the recommendations in this chapter, a good faith acquirer, lessee or licensee of the encumbered asset acquires the rights or benefits described in recommendations 161 and 162.

Intersection of movable and immovable property enforcement regimes

164. The law should provide that:

(a) The secured creditor may elect to enforce a security right in an attachment to immovable property in accordance with the recommendations in this chapter or the law governing enforcement of encumbrances on immovable property; and

(b) If an obligation is secured by both a movable asset and immovable property of a grantor, the secured creditor may elect to enforce:

(i) The security right in the movable asset under the provisions on enforcement of a security right in a movable asset and the encumbrance on the immovable property under the law governing enforcement of encumbrances on immovable property; or

(ii) Both rights under the law governing enforcement of encumbrances on immovable property.

Enforcement of a security right in an attachment

165. The law should provide that a secured creditor with a security right in an attachment to immovable property is entitled to enforce its security right only if it has priority as against competing rights in the immovable property. A creditor with a competing right in immovable property that has lower priority is entitled to pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the immovable property caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.

166. The law should provide that a secured creditor with a security right in an attachment to a movable asset is entitled to enforce its security right in the attachment. A creditor with higher priority is entitled to take control of the enforcement process, as provided in recommendation 145. A creditor with lower priority may pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the movable asset caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.

2. Asset-specific recommendations

Application of the chapter on enforcement to an outright transfer of a receivable

167. The law should provide that the recommendations in this chapter do not apply to the collection or other enforcement of a receivable assigned by an outright transfer with the exception of:

(a) Recommendations 131 and 132 in the case of an outright transfer with recourse; and

(b) Recommendations 168 and 169.

Enforcement of a security right in a receivable

168. The law should provide that, in the case of a receivable assigned by an outright transfer, subject to recommendations 117-123 (chapter VII on the rights and obligations of third-party obligors), the assignee has the right to collect or otherwise enforce the receivable. In the case of a receivable assigned otherwise than by an outright transfer, the assignee is entitled, subject to recommendations 117-123, to collect or otherwise enforce the receivable after default, or before default with the agreement of the assignor.

169. The law should provide that the assignee's right to collect or otherwise enforce a receivable includes the right to collect or otherwise enforce any personal or property right that secures payment of the receivable.

Enforcement of a security right in a negotiable instrument

170. The law should provide that, after default or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 124 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce a negotiable instrument that is an encumbered asset against a person obligated on that instrument.

171. The law should provide that the secured creditor's right to collect or otherwise enforce a negotiable instrument includes the right to collect or otherwise enforce any personal or property right that secures payment of the negotiable instrument.

Distribution of proceeds of disposition where the encumbered asset is a receivable, negotiable instrument or other claim

172. The law should provide that, in the case of collection or other enforcement of a receivable or negotiable instrument, or enforcement of a claim, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. The enforcing secured creditor must pay any surplus remaining to any subordinate competing claimant that, prior to any distribution of the surplus, notified the enforcing secured creditor of the subordinate competing claimant's claim, to the extent of the amount of that claim. The balance remaining, if any, must be remitted to the grantor.

Enforcement of a security right in a right to payment of funds credited to a bank account

173. The law should provide that, after default or before default with the agreement of the grantor, a secured creditor with a security right in a right to payment of funds credited to a bank account is entitled, subject to recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce its right to payment of the funds.

174. The law should provide that a secured creditor that has control is entitled, subject to recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors), to enforce its security right without having to apply to a court or other authority.

175. The law should provide that a secured creditor that does not have control is entitled, subject to recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce the security right in the right to payment of funds credited to a bank account against the depositary bank only pursuant to a court order, unless the depositary bank agrees otherwise.

Enforcement of a security right in a right to receive the proceeds under an independent undertaking

176. The law should provide that, after default or before default with the agreement of the grantor, a secured creditor with a security right in a right to receive the proceeds under an independent undertaking is entitled, subject to recommendations 127-129 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce its right in the right to receive the proceeds under the independent undertaking.

Enforcement of a security right in a negotiable document or a tangible asset covered by a negotiable document

177. The law should provide that, after default or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 130 (chapter VII on the rights and obligations of third-party obligors), to enforce a security right in a negotiable document or a tangible asset covered by the document.

IX. Acquisition financing

A. General remarks

1. Introduction

1. The purchase and sale of tangible assets is a key activity in a modern commercial economy. Almost every enterprise buys or sells this type of asset at some time or another. For some enterprises, the acquisition of raw materials and their subsequent processing and sale, or the purchase of inventory at wholesale for distribution to retailers or for resale at retail, are central activities. For other enterprises, although the purchase and sale of tangible assets is not the central activity, it may nonetheless be important to the extent that, for example, the enterprise requires an investment in equipment that may need to be augmented, upgraded or replaced from time to time.

2. However, the acquisition of tangible assets is not restricted to enterprises. Consumers are constantly purchasing tangible assets ranging from low-price consumer goods, to mid-range durable assets such as furniture, electronic devices and kitchen equipment, to high-value assets such as automobiles and recreational vehicles.

3. While in many cases the acquisition of tangible assets by enterprises or consumers is on a cash basis, in many other cases the assets are acquired on credit. Whenever an enterprise or consumer acquires tangible assets on credit, and rights in the acquired assets are to serve as security for credit, the transaction is a form of secured transaction that the *Guide* calls an “acquisition financing transaction”. The right that the seller or creditor retains or obtains in the acquired assets may be called an acquisition security right, a retention-of-title right or a financial lease right, depending on the precise character of the transaction.

4. Acquisition financing transactions are not only among the most important sources of credit for many buyers of tangible assets, but they are also critical to many sellers. For example, in many States the sale of automobiles normally involves an acquisition financing transaction. While buyers may seldom engage in such transactions for other purchases, the availability of acquisition financing to buyers is essential for sellers of automobiles. In many respects, acquisition financing transactions are identical to ordinary secured transactions as described in previous chapters of the *Guide*. However, in other respects they have particular features that have led States to provide for special rules in several situations. This chapter considers the ways in which States may achieve an efficient and effective regime to govern all types of acquisition financing transaction.

5. Specifically, this chapter discusses, in section A.2, the terms used in the *Guide* in view of the diversity of forms of acquisition financing. To clarify the substance of acquisition financing transactions further, section A.3 discusses their commercial background and section A.4 discusses the various approaches to acquisition financing followed in various legal systems. Section A.5 sets out the key policy choices that confront States enacting

legislation to govern the various types of acquisition financing transaction. The remainder of the chapter then reviews how the various components of a secured transactions regime discussed in other chapters of the *Guide* apply in the specific case of acquisition financing. It considers, in section A.6, the creation of such devices (their effectiveness as between the parties), in section A.7, the effectiveness of such devices as against third parties, in section A.8, priority of rights as against the rights of competing claimants, in section A.9, pre-default rights and obligations of the parties, in section A.10, enforcement, in section A.11, conflict of laws, in section A.12, transition issues, and in section A.13, issues relating to the treatment of acquisition financing transactions in insolvency. The chapter concludes, in section B, with a series of specific recommendations.

2. Terminology and diversity of forms of acquisition financing

6. Because of the number and diversity of acquisition financing transactions, it is important to indicate clearly how the *Guide* uses this term, as well as certain other terms. In several cases, these other terms coincide with terms currently in use in many States. The *Guide* makes a conscious choice in this chapter not to invent a series of new and, therefore, unfamiliar terms (with the exception of the term “acquisition financing”). However, the terms used here are meant to have the meanings provided in the terminology section of the *Guide* (see Introduction, Section B, Terminology and interpretation) and these meanings may well differ from the meanings of the same terms as used in any particular State.

7. In this chapter, the *Guide* uses the generic concept “acquisition financing” in order to embrace the full range of transactions that can be deployed to enable buyers to acquire tangible assets on credit. An acquisition financing transaction exists whenever a person (for example, a seller or lender) may claim a property right in tangible assets to secure another person’s obligation to pay any unpaid portion of their purchase price (or its economic equivalent). A transaction under which a seller retains ownership of (or title to) the assets sold for such a purpose is also an acquisition financing transaction. Thus, the key features of an acquisition financing transaction are three: (a) the credit is used for the specific purpose of enabling the buyer or lessee to acquire a tangible asset; (b) the rights being claimed or retained relate directly to the asset being acquired; and (c) the rights being claimed arise by virtue of an agreement.

8. As noted in section C of chapter I of the *Guide*, States have developed a wide variety of legal devices through which providers of credit can ensure repayment of their debtor’s obligation. While only some of these devices give rise to what are classically known as security rights, all serve the economic function of securing the repayment obligation.

9. A similar diversity of legal devices is typically available to those creditors that finance a buyer’s acquisition of tangible assets. For example, a seller that retains ownership of the asset being sold until the buyer has paid the purchase price in full (a retention-of-title seller) is extending credit to its buyer and is thereby financing the buyer’s acquisition of that asset. The retention-of-title right is just one of several devices available to sellers. A seller may also transfer title to a buyer with a proviso that the buyer’s title will be retroactively extinguished if it fails to pay the agreed purchase price (such a sale is referred to as being under a “resolutive condition”); or, a seller may transfer title to a buyer, but take a security right in the asset being sold.

10. Sellers comprise just one category of financiers that may provide credit to enable a person to acquire tangible assets. Lenders, too, may provide credit to a buyer for the specific purpose of enabling that buyer to purchase assets from a seller. In these cases, the lender normally would take a security right in the asset being purchased, although the lender might also purchase the asset and resell it to the buyer under a retention-of-title arrangement or obtain an assignment of the seller's claim for the purchase price and the accompanying retention-of-title right. Because both sellers and lenders may offer credit to buyers, it is possible for more than one person to be claiming a right in a particular asset under an acquisition financing transaction involving that asset.

11. Still another form of acquisition financing transaction may not even involve a contract of sale at all. A lessor that leases an asset to a lessee on terms that are economically equivalent to those of a sale on credit is likewise providing financing that enables the lessee to acquire use and enjoyment of the tangible asset as if it owned that asset, even if title never passes from the lessor to the lessee. As in the case of sellers, there are different ways in which lessors may structure the agreement so as to enable the lessee to acquire the economic equivalent of an ownership right in the leased asset. The *Guide* calls the right of the lessor in such cases a "financial lease right" (see Introduction, section B, Terminology and interpretation).

12. Finally, a lender that provides credit to a lessee for the purpose of making payments as they come due under a lease may, depending on the terms of the credit, be entitled to claim an acquisition security right in the asset being leased. If the credit being extended actually enables the lessee to enter into the financial lease agreement with the lessor, the lender is financing the lessee's use (and notional acquisition) of that asset.

3. Commercial background

(a) General

13. Section A.2 of this chapter summarized a number of different ways for a buyer to finance its acquisition of tangible assets such as equipment and inventory (whether raw materials or finished products). In this section, the commercial background of these various transactions and their actual operation in different States are considered in greater detail. This discussion is meant to illustrate the wide variety of transactions, involving a broad range of credit providers, which are being deployed to finance the acquisition of tangible assets, and to show the manner in which many transactions serve that purpose even though they are not denominated as such. The discussion is also meant to reveal that among the States that use these different transactions there is a great diversity both in their scope and their effect. Finally, by considering briefly the advantages and the drawbacks of each of these traditional types of transaction, the discussion aims to provide a context and rationale for the particular approach to acquisition financing recommended in the *Guide*.

(b) Unsecured and secured acquisition financing

14. An initial distinction to be drawn when considering the purchase and sale of tangible assets in a commercial setting is the distinction between cash sales and sales on credit.

Sometimes buyers have sufficient liquidity to purchase needed assets on a cash basis. As a rule, however, commercial enterprises acquire a substantial part of their equipment and inventory on credit.

15. When tangible assets are purchased on credit, the buyer often obtains the credit on an unsecured basis. This normally occurs in one of the following two ways. First, a buyer might simply borrow an amount equal to the purchase price from a third party on an unsecured basis. For example, while the sale transaction is itself a cash transaction, it may effectively be financed by a general line of credit from the primary lender to the enterprise. This method is simple, but the buyer's credit rating or reputation might make it difficult for a buyer to obtain such credit or make the cost of such credit prohibitively high.

16. Alternatively, a buyer may agree with a seller to purchase the asset on credit terms that allow the buyer to make payment after the completion of the sale. Here the seller transfers possession and ownership of the asset to the buyer but is paid the purchase price at a later time, either in a lump sum or through periodic instalment payments. This method is not really different from third-party finance except that the risk of non-payment is now borne by the seller rather than by a third-party financier. Many sellers are, however, either unable or unwilling to bear such an unsecured risk.

17. As a result, buyers often find that, as a practical matter, unsecured acquisition financing is not available to them and, therefore, they must provide some form of security in order to acquire tangible assets on credit. The assets that serve as security could well be existing assets of the buyer other than the assets being acquired. For example, an enterprise could grant security over its factory or warehouse to secure repayment of a loan to be used to acquire equipment and inventory. Typically, however, the most obvious asset in which security may be taken and, frequently, the only such asset available to a buyer, is the asset actually being acquired.

18. Security for acquisition financing in the assets being acquired can arise in several different ways. In some States, sellers have special rights arising by operation of law that enable them to cancel the sale and take back the asset sold if the buyer does not pay the purchase price within a certain period after delivery. Other States give sellers an automatic statutory priority or preference in the distribution of proceeds of a judicial sale of the asset they have supplied. Often, however, the security right claimed by an acquisition financier does not arise by operation of law, but is the result of an agreement between the seller or lender, on the one hand, and the buyer, on the other hand.

19. As a matter of commercial practice, most acquisition financing is of the type just described. As noted (see paras. 8-12 above), these acquisition financing transactions can take many forms and involve different providers of credit. For example, the buyer may formally grant a security right in the asset to a third-party financier; the buyer may formally grant such a security right to the seller; or the buyer and seller may agree to some other legal mechanism that, although not in the form of a security right, is its economic equivalent. Historically, two such other mechanisms, both using ownership of the asset to secure payment, have played a central role in acquisition financing. These mechanisms are: (a) the seller's retention of title to the asset until the purchase price is paid; and (b) the use of a transaction structured in the form of and denominated as a lease. They are

considered below in turn, prior to a review of modern acquisition financing mechanisms available to both sellers and lenders.

(c) *Retention-of-title and similar transactions*

20. A seller of equipment and inventory may wish to meet its customer's need for credit by supplying the asset to the customer under an agreement by which ownership does not pass to the buyer until the purchase price has been paid in full. In many cases, the agreement is between the seller and the buyer without any intermediary. In some cases, however, the seller may sell the asset for cash to a bank or other financial institution, which may then resell the asset to the buyer under an agreement that provides for reservation of ownership until full payment of the purchase price.

21. There are various types of agreement through which sellers may reserve ownership of the assets sold until full payment of the purchase price. The retention-of-title mechanism is very common. In this type of transaction, the buyer's right to obtain title is conditional upon its paying the purchase price. Until then, the seller is not required to transfer ownership of the asset being acquired to the buyer, even though the buyer usually obtains immediate possession of the asset and the right to use it.

22. Retention-of-title arrangements are sometimes called "conditional sales". Generally, however, this is a misnomer. In most transactions called conditional sales, the sale itself is not conditional (that is, the actual sale agreement is not dependent on the occurrence of some future and uncertain event not related to the sale itself). Rather, under such a "conditional sale", it is only the transfer of ownership to the buyer that is conditional. The seller reserves ownership of the asset sold until the purchase price has been paid in full or the buyer has complied with any other conditions prescribed in the sale agreement.

23. In addition to retention-of-title arrangements, there is a variety of other transactions in which a seller uses ownership to secure the unpaid purchase price of an asset it sells. For example, sometimes the reservation of a seller's ownership is structured as a sale with a term, and the transfer occurs only at the end of the stipulated term. In other transactions, possession of the asset is delivered to the purchaser under a "promise of sale" or an "option to purchase". Some States attempt to regulate these latter transactions by providing that a promise of sale accompanied by delivery is equivalent to a sale. Occasionally, a seller will actually transfer ownership to a buyer at the time of sale, with a proviso that the buyer's title will be retroactively extinguished should it fail to pay the agreed purchase price according to stipulated terms.

24. In each of these cases, the key feature is that the agreement by the seller to postpone full payment (that is, to offer credit) is protected either by delaying the passing of title to the asset to the buyer or, less commonly, by transferring title to the buyer subject to the seller's right to regain title upon the buyer's failure to pay. In either case, the idea is that the buyer does not irrevocably acquire ownership of the asset being sold until the purchase price is fully paid.

25. Another form of transaction that has been used to serve the same economic function is a "consignment". The typical consignment structure is as follows. The consignor (the

notional seller) retains ownership of tangible assets (typically inventory held for resale), but transfers possession to the consignee. The consignee is authorized to sell these assets to a third party. Upon such a sale, the consignee is obliged to remit to the consignor an agreed amount. In the case of a true consignment, the consignee has no absolute obligation to acquire the consigned assets and to pay the agreed price; its obligation is either to pay the agreed price or to return the assets to the consignor (a right that a “true” buyer does not have). Thus, it is critical to examine the nature of the consignee’s obligation: if the consignee is obligated to pay the price in all events, but with payment deferred until the assets have been sold by the consignee and the ownership of the assets is retained by the consignor to function as security (like a retention-of-title transaction), then it fits into the category of an acquisition financing transaction discussed in this chapter. Moreover, the transaction will be an acquisition financing transaction even in cases where ownership of the consigned assets never formally passes to the consignee, but rather is transferred directly from the consignor to the third party that purchased them from the consignee.

26. The most common of the above arrangements in which the seller uses title to the assets being sold as a means to secure payment of the purchase price is the retention-of-title transaction. In some States, the basic transaction may be varied through different types of clause that greatly expand its usefulness as an acquisition financing device. Thus, for example, the parties may be permitted to agree to an “all-monies” or “current account” clause. Under such a clause, the seller retains ownership of the asset sold until all debts owing from the buyer to the seller have been discharged (and not just those arising from the particular contract of sale in question). This means that the seller will be able to assert its retained ownership rights in the asset sold against all other potential claimants until the unpaid purchase price for all other assets sold by the seller to that buyer has been paid in full.

27. In addition, in some States parties are permitted to add “products” clauses, in which the seller’s ownership is extended to, or the seller is deemed to have a security right in, any products that are manufactured from the asset in which the seller retained ownership. Similarly, some States allow for “proceeds” clauses, under which sellers may claim ownership or a security right in any proceeds, such as receivables, generated by the sale of the assets in which they have retained ownership, although this is quite rare (for the treatment of proceeds in the case of ordinary security rights, see chapter II on the creation of a security right, paras. 72-85; see also recommendations 19 and 20). In most of the States that permit “proceeds” clauses, however, the seller’s right in the proceeds is not ownership, but is an ordinary security right that does not benefit from any special priority.

28. While there are great divergences in the extent to which States permit modification of the basic retention-of-title transaction, many adopt a traditional posture. In these States, the applicable law strictly limits the scope of the seller’s retained ownership. Usually, the right may be claimed: (a) only in the tangible asset sold and not in any receivables or other proceeds of the disposition or replacement of such asset; (b) only so long as the asset retains its original identity unaltered by the manufacturing process; (c) only to secure the sale price of the particular asset, and not other amounts owing by the buyer to the seller.

29. Given the continued centrality of retention-of-title devices in many States (and notwithstanding that many common law States use the term “conditional sale” to describe such devices), this chapter will use the expression “retention-of-title right” generically.

This expression refers to the right of a supplier under all types of sales transaction where a buyer does not irrevocably acquire ownership of the asset being sold until the purchase price is fully paid.

(d) *Leases, hire-purchase transactions and financial leases*

30. A supplier may also use the concept of a lease to enable its customers to acquire the use of an asset without immediately having to pay its purchase price. As with sales transactions, there is a variety of lease transactions that can be used as acquisition financing mechanisms. In many cases, a supplier of equipment may simply lease a piece of equipment to an enterprise that takes possession of the equipment and makes monthly rental payments. Under this arrangement, the supplier retains ownership of the equipment as a lessor and the lessee merely pays the rent as it falls due. While it is conceivable that such a lease arrangement could involve raw materials or other inventory, parties typically use these types of transaction to enable enterprises to acquire the use of equipment such as machinery, motor vehicles, computers, photocopiers, display racks and office furniture.

31. In many cases, the lease agreement is structured to achieve the functional equivalent of a retention-of-title sale. For example, the term of the lease may be for the useful life of the equipment being sold so that at the end of the lease the lessee has enjoyed the equivalent benefit to having owned the equipment, whether or not ownership ever passes to the lessee and whether or not the lessee has an obligation to purchase the equipment at the end of the lease. Alternatively, the lease period could be for less than the useful life of the equipment but, at the end of the lease period, the lessee has the option to purchase the equipment for a nominal price or to extend the lease term for the remaining useful life of the equipment. In some States, this type of lease arrangement can only exist if the lessee is not obliged or even entitled to acquire the leased asset. In these States, it is the fact that ownership is never transferred that distinguishes a lease from a retention-of-title sale. Nonetheless, the existence or non-existence of an eventual right to obtain the transfer of title is not relevant to whether the transaction should be characterized as an acquisition financing transaction. Whenever the transaction is denominated as a lease, what really qualifies it as an acquisition financing transaction is whether the lessee is acquiring the use of the asset for at least most of its useful life in exchange for notional rental payments that represent the economic equivalent of its price if it had been sold in an instalment sale.

32. In a number of States, a similar result to a retention-of-title sale is achieved through devices called “hire-purchase transactions”. However, not all States use this expression to identify the same arrangement. In some States, the hire-purchase arrangement commences with the lessee (hire-purchaser) selecting the equipment from the supplier (hire-seller) of the equipment. The lessee then applies to a leasing company (usually a financial institution or an affiliate of one) to purchase the equipment from the supplier for cash and to lease it to the lessee (hire-purchaser). As with an ordinary financial lease, very often the period of the lease comprises the useful life of the equipment and, at the end of the lease period, the lessee automatically acquires ownership or has the option to purchase the equipment for a nominal sum. In other States, the expression is used to cover transactions where an enterprise leases the asset directly from the manufacturer and either automatically acquires ownership or has the option to purchase the equipment at the end of the lease period. For the purposes of this *Guide*, the expression is meant to cover any

transaction that starts out as a lease arrangement but contemplates that the lessee will acquire ownership of the asset at the end of the lease period.

33. Yet another acquisition financing transaction that takes the form of a lease is what many States label a “financial lease” or a “finance lease”. In these States, financial leases are granted special tax advantages that have the economic effect of reducing the cost to the lessee. Whether the financial lease agreement is a two-party arrangement between lessor and lessee or a three-party arrangement that involves a third-party financier that acquires the asset and then leases it to the lessee, the transaction takes the form of a lease. Despite the form of the transaction, in each case the economic reality is that the lessee is paying the notional purchase price for the equipment in instalments, while the lessor remains the owner until full payment is made. It is important to note, however, that the economic effects of such a transaction as an acquisition financing mechanism are not necessarily related to how a financial lease may be characterized for tax purposes. Consequently, a transaction may be a financing lease for secured transactions purposes although not one for tax purposes, or vice versa (see Introduction, paras. 26-27).

34. States that make general use of transactions in the form of leases as acquisition financing devices not only use different terms to describe these transactions, they also attach different consequences to their use. In some States, the lessee is able to sell the leased asset and a good-faith purchaser will be able to assert ownership of the asset against the lessor. In a few of these States, however, the lessor may be able to claim a right in the proceeds of the sale. In other States, the lessor may always be able to claim its right against a person that purports to have acquired the asset from the lessee. Additionally, in some States a lessor is able to reclaim the asset without the need for a judicial order if the lessee is in default. In other States, the lessor must first seek formal termination of the contract, and reclaim possession judicially. Finally, in some States these transactions are strictly regulated by mandatory rules, while in others the specific leasing arrangements are tailored to the lessee’s unique cash-flow requirements, the national tax regime and other needs of the lessor and lessee.

35. The above discussion reflects a great diversity in these lease transactions. Depending on the nature of the equipment at issue, lease periods may range from a few months to several years and items leased may range from high-value equipment, such as aircraft, to lower-value equipment, such as computers. In all cases, however, and whatever may be the definition given to a financial lease for tax or accounting purposes in any State, in this chapter the expression “financial lease right” will be used generically to refer to all transactions that take the form of a lease but where the economic reality is that of a retention-of-title sale (that is, where the functional equivalent of ownership will be enjoyed by the lessee during the period of the lease, regardless of whether formal title to the asset is ever transferred to the lessee).

(e) Security rights and other privileged rights of sellers

36. In many States, several other legal devices are available to secure the performance of a buyer’s payment obligations. In some cases, the seller’s rights under these devices arise by operation of law. These statutory rights typically presuppose that ownership of

the asset being sold has passed to the buyer. For example, the seller of tangible assets may be given a high-ranking “privilege” or a “preferential claim” (often called a “vendor’s privilege”) on the money generated by a judicial sale or other sale in execution of these assets. Whether the sale is initiated by a seller that has obtained a judgement against the buyer, by another judgement creditor of the buyer or by a secured creditor exercising a security right against the assets, the seller may claim its statutory priority. This statutory preferential right usually has a priority superior even to that of secured creditors that have acquired their rights by agreement.

37. In some States, a seller also has a right to refuse to deliver tangible assets to a buyer that is not ready to pay the price at delivery. This right to refuse delivery usually also includes a right to interrupt the transport of assets by a carrier, also known as the “right of stoppage in transit”. Occasionally, this right is projected forward as a reclamation right for a short period (for example, 30 days) after delivery of the assets. None of the statutory rights referred to in this and the preceding paragraph is particularly effective as a means for financing the acquisition of assets, however, since they invariably require that the assets retain their original identity.

38. In addition to these statutory rights arising under the contract of sale, traditionally sellers were also permitted to take a regular security right in the assets they sold. In many States, however, this was not an effective mechanism given the absence of a non-possessory security device. For example, a seller that transferred ownership of an asset to a buyer would then have to keep or retake possession of that asset as a pledge. By contrast, other States have long permitted sellers to take non-possessory security, often in the form of a “chattel mortgage”. More recently a number of States that previously did not allow the hypothecation of movable assets have modified their law to permit a seller to contract for a non-possessory security right in the assets it sells. This type of seller’s security right is usually available only in States that have also decided to permit lenders to take non-possessory security rights over tangible assets.

39. The development of non-possessory security rights in favour of a seller has usually been accompanied by another development. Sellers that take security are able, if they follow the appropriate procedure, to assert a priority over all other security rights granted by the purchaser in the asset being acquired. These competing claims would arise, notably, in the case where the purchaser had previously granted a security right to a lender over future assets of the type being acquired. In some States, this special seller’s security right is called a “vendor’s hypothec”; in other States, it is called a “supplier’s lien” or “supplier’s charge”; in still other States, it is called a “purchase-money security interest”. The name is of little consequence. What matters is that: (a) the seller’s non-possessory security right is identical in form to the non-possessory security right that may be taken by an ordinary lender; and (b) the seller that takes such a security right is usually able to claim a preferred priority position that allows it to outrank any other secured creditor that is asserting a security right in the asset granted to the seller by the buyer.

(f) *Lender acquisition financing*

40. In most modern economies, lenders provide a substantial proportion of acquisition financing. Historically, however, many States placed significant limitations on a

lender's capacity to provide acquisition financing. For example, it was often not possible for buyers to grant non-possessory security over assets they were in the course of acquiring. Today, several States that permit lenders to take non-possessory security still do not permit them to obtain a special priority when they provide acquisition financing. That is, even in cases where the money advanced to the buyer is specifically intended to be used to purchase assets and is in fact used for that purpose, the lender that takes security in those assets is considered to be an ordinary secured creditor subject to the ordinary priority rules governing security rights. As a result, a lender that specifically provides acquisition financing for a particular asset will rank lower than a pre-existing secured lender with a security right in the buyer's future assets of the type being purchased.

41. In these States, the only mechanism by which lenders could achieve the same preferred status as sellers and lessors was to acquire the rights of the seller or lessor. Thus, where sellers retained ownership to secure the buyer's payment obligation, sometimes lenders would directly pay the purchase price to the seller and take an assignment of the seller's right to payment under the sale agreement, along with the seller's retention-of-title right. Similarly, in cases where the law enabled sellers to take a consensual security right with a special priority status in the asset being sold, the lender could purchase the seller's security right. Finally, in cases involving financial leases, the lender would sometimes purchase the lease contract from the lessor. While these lender's rights that are derived from sellers permit lenders to enter the acquisition financing market, they do not promote open competition among credit providers, since: (a) either the consent of the seller will be required, often at a cost to the lender (ultimately borne by the buyer), or the lender will have to engage in multiple transactions, involving, for example, the purchase of and subrogation to the seller's rights, in order to achieve the desired outcome; and (b) the lender will be required to become the owner of the asset being acquired, a status it may not wish to assume for tax, product-liability exposure or other reasons.

42. In order to promote competition for acquisition financing, some States permit lenders that provide acquisition financing to buyers of tangible assets to obtain, in their own name, a preferential security right in those assets. In other words, in these States it is possible for lenders to achieve a priority status that was previously available to them only by acquiring the preferential right enjoyed by sellers. However, not all lenders that provide money to an enterprise that might ultimately be used to purchase tangible assets will be able to claim an acquisition security right. To be able to do so, the lender must advance the credit to enable the purchaser to acquire the assets and the credit must actually be used for that purpose; in all cases, the right can only be claimed in the assets thereby acquired.

43. Even though this special type of lender acquisition security right may be found in a number of States, the idea that a lender might be able to claim a preferential acquisition security right directly is not broadly accepted. Indeed, most States that permit sellers to secure the purchase price of the assets being sold through a distinct retention-of-title right do not permit lenders to claim preferential acquisition security rights. In these States, lenders as well as sellers may take non-possessory security, but typically only sellers are permitted to claim a preferential acquisition security right, which they may do as an alternative to retaining ownership.

4. Approaches to financing the acquisition of tangible assets

(a) General

44. In the past, States have taken a wide variety of approaches to regulating acquisition financing transactions. Typically, however, protecting the rights of sellers was conceived as the central objective. Moreover, until recently, in many States it was not possible for a buyer to grant a non-possessory security right in tangible assets, even to a seller. For these two reasons, the retention-of-title technique developed as an everyday practice in civil law, common law and other systems. Sometimes States enacted legislation to acknowledge and regulate this acquisition financing technique. Most often, however, they did not do so, with the result that the contemporary law of acquisition financing in these States emerged from contractual practices that were later explicitly recognized and further elaborated by courts.

45. In order to appreciate the policy choices relating to acquisition financing now open to States, it is helpful to consider briefly three of the common approaches that have been taken to acquisition financing: (a) approaches that favour seller-based acquisition financing; (b) approaches that promote both seller- and lender-based acquisition financing as complementary but distinct mechanisms; and (c) a fully integrated approach to acquisition financing that does not conceptually distinguish between sellers and lenders.

(b) Approaches favouring seller-based acquisition financing

46. As noted above, the development of the law of acquisition financing in many States focused on the protection of sellers. In no State did the legislature and courts set out to prevent financial institutions from providing acquisition financing. However, because this field was conceived as an adjunct to the law of sales, in these States retention-of-title and economically equivalent devices were available uniquely to sellers, as opposed to financial institutions. As a result, these devices became the main, if not the exclusive, acquisition-financing devices that enabled buyers to obtain possession of the assets being purchased.

47. The character and effects of retention-of-title mechanisms vary widely from State to State. Many of these differences are products of history and the specific contractual practices that were adopted in response to and frequently to overcome limitations imposed by the legal rules in place in individual States. Thus, the law in this field has tended to develop in a haphazard way with novel contracts and additional terms to well-known types of agreement being invented piecemeal, as the need arose, to serve as proxies for a fully developed regime governing acquisition financing transactions. Consequently, the everyday contractual practices sometimes are not coherent with the legislative policy reflected by the current law in a State, and do not reflect the kinds of practices that enterprises would adopt if the legal regime were designed to promote efficient secured credit.

48. The approach that focuses on sellers as the principal source of acquisition financing has occasionally been based on a policy decision to protect small- and medium-sized suppliers of tangible assets against large financial institutions. The approach acknowledges the importance of these manufacturers and distributors for the domestic economy and the dominant position of large institutions in credit markets. The policy decision to afford

special treatment for sellers is often grounded in a number of assumptions. One is that suppliers have an interest in providing credit at low rates to increase the volume of their sales. Another is that the cost of such credit is affordable because many suppliers do not charge interest prior to default. A third is that, because there will usually be several suppliers seeking to sell tangible assets to any given buyer, competitive prices will be offered to buyers.

49. A State considering secured transactions law reform needs to evaluate these assumptions carefully. While some may be justified, others may not. For example, the first assumption is invariably true. With respect to the second assumption, however, the fact that a supplier sells assets to a buyer under a retention-of-title arrangement does not necessarily mean that the seller's credit terms come at no cost to the buyer. The supplier itself has a cost of obtaining funds in order to extend these credit terms and presumably that cost of funds will be embedded in the price of the assets being sold and passed on to the buyer. As for the third assumption, although competition may be enhanced among sellers, additional competition (which could further lower the cost of the assets) would be created if non-sellers were also enabled to finance the acquisition of these assets.

50. Even if a State interested in promoting the manufacture and supply of tangible assets wishes to encourage sellers to act as providers of credit, it need not, and should not, do so to such an extent that other parties are excluded from offering competitive acquisition financing. In the same way that competition among sellers normally reduces prices for buyers, competition among providers of credit normally reduces the cost of credit to buyers and increases its availability. Fostering competition among all providers of credit will not only result in credit being available to the buyer at the most affordable rates, but is also likely to open up new sources of credit for buyers. This, in turn, will increase their capacity to purchase tangible assets without the need for sellers themselves to provide financing to all of their potential buyers.

51. Legal barriers that prevent financiers other than sellers and lessors from directly extending acquisition financing to buyers, or that require these other financiers to extend credit only through the seller or lessor by taking an assignment of the seller's retention-of-title right or the lessor's financial lease right, can be inefficient in other respects as well. Most importantly, treating acquisition financing simply as a matter of protecting the property rights of sellers and lessors may actually reduce the scope of the rights otherwise claimable by those sellers and lessors. This is because many modern secured transactions regimes offer secured creditors a number of rights that often have not, or not always, been available to sellers that use retention of title to secure their claims. These rights include, for example: (a) an automatic right to claim a security right in any products that are manufactured from the assets in which a security right is granted and in any proceeds generated by the sale of the encumbered assets; and (b) the ability to use the security right to secure all debts that may be owing from the buyer to the seller.

(c) Approaches promoting both seller- and lender-based acquisition financing

52. In part to expand the range of potential providers of acquisition financing to buyers and in part to enable sellers to avail themselves of a full panoply of rights previously available to lenders that took security rights, many States have redesigned their acquisition

financing regime so as to promote both seller- and lender-based acquisition financing. Different approaches have been taken to achieve this outcome.

53. In some States that recognize special acquisition rights for sellers based on a reservation of ownership, retention-of-title sellers are now able to expand their rights by contract through the insertion of additional clauses into the agreement of sale. In these States, retention-of-title sellers are often permitted to insert a clause in the sale contract extending the seller's right into assets manufactured from the asset initially sold, or a clause (often referred to as an "all sums clause") allowing the retention of title to specific tangible assets to stand as security for all obligations owed to the seller by the buyer. In rare cases, a State will also permit a retention-of-title seller to insert a clause in the sale contract extending the seller's right to receivables or other proceeds arising from the sale of the goods. Nonetheless, in most States that maintain special sellers' rights based on a reservation of ownership, only the simple retention of title is treated as a title device, while these other, more complex retention-of-title arrangements are either not recognized or are treated as giving rise to security rights or fiduciary or other rights. It also bears notice that some States have also enhanced the rights of buyers under a retention-of-title arrangement by recognizing a buyer's expectancy right in assets being acquired under a retention-of-title arrangement and permitting the buyer to grant a lower-ranking security right in the assets (or, in the case of tangible assets to be acquired in the future, the expectancy of receiving such assets) in favour of another creditor.

54. A few States have reformed their secured transactions legislation to enable sellers to take preferential acquisition security rights, but still permit retention of title, financial leases and similar devices to coexist as separate acquisition financing transactions. In these States, the various devices by which ownership is used to secure a buyer's obligation are, however, usually regulated by substantially the same set of rules as those applicable to a seller's acquisition security rights. Still other States maintain traditional sellers' acquisition financing rights alongside sellers' acquisition security rights, but also allow lenders to claim security rights in the assets being sold. To avoid the risk of imperfect coordination among various types of acquisition financing, these States often go further and require sellers to register a notice of a retention-of-title right in the security rights registry, and to follow the same procedures for enforcement that would apply to enforcement of a security right.

55. This last approach is based on a policy decision to provide, as far as possible, for the equal treatment of all transactions that are used to finance the acquisition of tangible assets. That is, in those States the goal is to extend the benefits of the regime of security rights to sellers that retain title, while at the same time subjecting these sellers to the same procedural regime that applies to lenders. Attempting to create more or less equal opportunities for all credit providers in this way, it is assumed, will enhance competition among them, thereby increasing the amount of credit available and reducing its cost to the benefit of both sellers and buyers. These types of reformed regime thus integrate sellers' and lessors' rights into the secured transactions regime, thereby facilitating financing on the basis of security of the buyer's or lessee's expectancy. At the same time, however, these regimes do not permit lenders that provide acquisition financing to compete directly for a first-ranking right in the assets being purchased. In other words, while these States have adopted regimes that go a long way towards achieving equal opportunities for the provision of acquisition financing, there is still a preferred priority status that is afforded to sellers over lenders that provide acquisition financing.

(d) *Approaches based on the fully integrated “purchase-money” security right concept*

56. Some States have taken an additional step. Not only have they adopted an approach that permits and promotes both seller and lender acquisition financing, but they have also enacted regimes that treat all providers of acquisition financing equally. In these States, lenders can acquire the same preferential priority as sellers that take security rights in the assets they sell. For regulatory purposes, the various acquisition financing rights of owners (retention of title, financial leases and similar devices) are: (a) fully integrated into a single, functional security right; and (b) treated identically to the standard acquisition security rights available to sellers and lenders. In many States that have adopted this approach, these various acquisition security rights are all characterized as “purchase-money” security rights.

57. Where the purchase-money security rights approach has been adopted, two important principles govern its application. The first is that a purchase-money security right, to which the *Guide* refers as an “acquisition security right”, is a generic, comprehensive concept. That is, it is applicable to any transaction by which a financier provides credit to enable a buyer to purchase tangible assets and holds a right in the assets being purchased to secure repayment of that credit. The second is that a purchase-money security right is a category of security right. That is, except where the particular circumstances of acquisition financing require a special rule applicable only to such rights, all the rules applicable to security rights generally also apply to acquisition security rights (see the term “acquisition security right”, Introduction, section B, Terminology and interpretation).

58. The following are the main features of the acquisition security rights regime in States that have adopted the fully integrated, purchase-money security right approach:

(a) The right is available not only to suppliers of tangible assets but also to other providers of acquisition financing, including lenders and financial lessors;

(b) The acquisition secured creditor is given, for secured transactions purposes, a security right, regardless of whether the creditor retains title to the assets being acquired;

(c) The buyer may offer a lower-ranking security right in the same assets to other creditors and is thus able to utilize the full value of its rights in the assets being acquired to obtain additional credit;

(d) Whether the agreement creating the acquisition security right is denominated as a security right, a retention-of-title right or a financial lease right, the acquisition secured creditor, like other secured creditors, normally has to register a notice of its security right in the general security rights registry;

(e) Once a notice of the acquisition security right is registered in the general security rights registry, the acquisition security right is effective against third parties;

(f) If the notice is registered within a short period of time after delivery of the assets to the buyer, or prior to delivery in the case of inventory, the acquisition security right will normally have priority over competing claimants, including a creditor with a pre-existing security right in future assets of the buyer; and

(g) The acquisition secured creditor that is a seller or a financial lessor may enforce its rights, within or outside insolvency proceedings, in the same way as any other secured creditor and does not have any title-based enforcement rights.

59. During the last few decades of the twentieth century and the first decade of the twenty-first century, an increasing number of States have adopted this fully integrated approach to acquisition financing. This trend may also be seen at the international level. For example, in the case of certain aircraft and other high-value mobile equipment, the Convention on International Interests in Mobile Equipment¹ governs the effectiveness against third parties of retention-of-title sales and financial leases with rules that are separate but substantively similar to the rules regulating security rights. Accordingly, it extends the international registry contemplated by the Convention beyond security rights to retention-of-title and to financial leasing arrangements. Moreover, under the United Nations Assignment Convention² the same rules apply to: (a) security assignments; (b) assignments for security purposes; and (c) outright assignments (see article 2, paragraph (a)), thus avoiding drawing a distinction between security rights and title-based devices. Indeed, article 22 of the Convention, which expressly covers various priority conflicts, includes a conflict between an assignee of receivables and a creditor of the assignor whose retention-of-title rights in tangible assets extend to the receivables from the sale of those assets. Finally, the same approach to acquisition financing is followed in the European Bank for Reconstruction and Development Model Law on Secured Transactions,³ the Organization of American States Model Inter-American Law on Secured Transactions⁴ and the Asian Development Bank's Guide to Movable Registries.⁵

5. Key policy choices

(a) General

60. In chapter I, section C, the *Guide* reviews the basic approaches to security and recommends an approach that might be adopted by a State seeking to reform its secured transactions law. A key question addressed in that chapter is how to treat transactions that fulfil the economic function of a security device but are effectuated by utilizing title to an asset to secure the full payment of the financier's claim. This question arises in contexts both inside and outside insolvency. Four different approaches are common among States that have recently reformed their secured transactions laws.

61. First, many of these States continue to maintain a formal diversity of financing devices in all situations. That is, they recognize both security devices and devices such as retention of title, fiduciary transfers of title, mortgages and sales with a right of redemption where a transfer of ownership of a borrower's assets is made to secure performance of an obligation. In these States, each transaction is governed by its own particular conceptual logic, be this as security, sale or lease.

62. Second, other States maintain this formal diversity of financing devices in non-insolvency situations, but under their insolvency regimes characterize as security devices all transactions where the right of ownership is used to secure payment of a creditor's claim. In these States, all transactions that fulfil the economic role of security are treated as functionally equivalent for insolvency purposes.

¹See Introduction, footnote 8.

²See Introduction, footnote 7.

³See Introduction, footnote 3.

⁴See Introduction, footnote 9.

⁵See Introduction, footnote 6.

63. Third, other States have extended this “functional equivalence” approach to non-insolvency as well as to insolvency contexts. The regimes in these States recognize the distinctive character of each of the various transactions involving title. Sellers are still permitted to engage in retention-of-title or resolatory sale transactions, and lenders are still permitted to engage in secured transactions or sale transactions with a right of redemption. However, to ensure proper coordination among these various transactions, and also to ensure, as far as possible, their equal treatment, these States subject all such transactions, however denominated, to a comprehensive regulatory framework that produces functionally equivalent outcomes.

64. Fourth, an increasing number of States carry this functional logic to its conclusion and adopt what might be called a functionally integrated and “unitary” approach. Their secured transactions regimes characterize as security all the various transactions fulfilling the economic function of security, regardless of their form, and explicitly denominate them as security rights. That is, in these States, the regime does not simply maintain a diversity of title mechanisms that are treated as functionally equivalent to secured transactions. The regime actually recharacterizes all these title mechanisms as secured transactions if they perform the economic function of a secured transaction.

65. The *Guide* recommends that States should adopt this last approach with respect to non-acquisition secured transactions. All non-acquisition secured transactions where rights in the grantor’s assets, including ownership, are used to secure an ordinary repayment obligation by a borrower to a provider of credit should be treated as security devices, and identified as such, in contexts both inside and outside insolvency (see recommendation 8). The *Guide* calls this the “functional, integrated, comprehensive and uniform” approach (see chapter I on the scope of application, paras. 110-114). There are three main advantages of such an approach: (a) it more obviously promotes competition among credit providers based on price and thus is more likely to increase the availability of secured credit; (b) it better enables legislative policy decisions to be made on grounds of comparative efficiency; and (c) because all transactions creating security rights are treated the same, the regime is easier to enact and apply.

66. When the obligation being secured is the payment of the purchase price of a tangible asset (that is, where an acquisition financing transaction is involved), a conceptually more complex issue is presented, since the parties involved are not all lenders. They are also sellers. In deciding whether to adopt the functionally integrated approach, therefore, States will have to determine whether: (a) the logic of secured transactions should override the logic of the law of sale and lease (or more particularly the logic of the law of ownership) when sellers and lessors use these transactions to secure the payment of the purchase price (or its economic equivalent) of tangible assets; or (b) the logic of sale and lease should override the logic of secured transactions as the primary organizing principle in these cases. In order to decide these issues, States must, first of all, consider whether the approach of providing functionally equivalent outcomes should be adopted as the most efficient way to reach the goal of substantial equality among acquisition financiers; and second, if so, States must consider whether the integrated approach should be adopted as the most efficient way to produce a framework of rules that achieves functional equivalence of outcomes.

(b) *Functional equivalence: a generic concept of acquisition financing*

67. There are good reasons of economic policy why States might wish to adopt the functionally integrated approach to acquisition financing. In market economies, creating equal opportunities for all credit providers will enhance competition among them, thereby potentially increasing the amount of credit available and reducing its cost. There is no overriding reason of economic principle why the manufacturer or distributor of tangible assets should have a monopoly on providing credit to purchasers. Once it is accepted that financiers should be able to compete to offer buyers access to acquisition financing, the legal regime under which they do so should not create incentives for one or another subgroup of financiers. The most efficient way to ensure that competition for the provision of credit is based solely on the terms and conditions offered by the financier is to establish legal rules that treat all of these financiers in a way that produces functionally equivalent outcomes.

68. It follows that buyers should be permitted to seek out the best deal possible to satisfy their acquisition financing needs. They should have equal opportunity to negotiate, with any potential financier, the terms of the loan or other form of credit, including the conditions of repayment, the interest to be charged, the events that would constitute a default and the scope of the security they provide. If the legal regime permits some financiers to obtain better security rights than others, this equality of opportunity to negotiate is compromised. In other words, from an economic perspective, there is nothing unique about acquisition financing that would induce a State to take an approach to credit competition different from the approach that it adopts in relation to ordinary non-acquisition financing.

69. There are also reasons relating to the design of legal institutions why a State might wish to adopt the approach that aims at producing functionally equivalent outcomes. As noted above (see paras. 36-39), States have traditionally organized credit for buyers of tangible assets by providing specific entitlements for sellers (possibly on the assumption that sellers would provide most acquisition financing and most sales would be one-off transactions relating to individual items). Under such an assumption, the primary concern was simply to ensure that, if the buyer did not pay the purchase price, the seller could recover the sold asset quickly, efficiently and free of any third-party rights. That is, credit was no more than an adjunct to the sale, and the seller's primary interest was to receive value for the asset provided to the buyer. Two developments over the past several decades have required States to rethink this position.

70. First, as economies expanded, the need for acquisition financing grew and sellers found that often they could not meet all the credit needs of their buyers. Especially where manufacturers, wholesalers and retailers were purchasing large quantities of raw material and inventory, it became increasingly common for banks, finance companies and other lenders to extend credit to buyers for the express purpose of enabling them to acquire these raw materials and inventory. Second, the types of equipment needed for manufacturing and distribution became increasingly sophisticated and expensive. Suppliers frequently were unable to provide the necessary financing to their prospective buyers. Moreover, often for tax reasons, buyers discovered that it was sometimes more economically advantageous to acquire needed equipment by a transaction structured in the form of and denominated as a lease rather than a purchase transaction. Frequently, these lease transactions were designed to achieve the economic equivalent of a sale on credit.

71. In both of these cases, acquisition financing was being provided to a buyer (or, in the case of a lessee, a notional buyer) by a person other than the direct seller of the assets. States were then confronted with having to decide whether continued reference to the seller's rights as the paradigm for acquisition financing transactions was justifiable. The main reasons for concern lay in the fact that: (a) sellers were traditionally able to get a top-ranking secured right in the assets based on their ownership, but other acquisition financiers such as lenders typically were precluded from obtaining a top-ranking right; and (b) when the transaction was structured as a lease rather than as a sale in which the seller transferred title to the buyer against a right to have the sale set aside for non-payment of the purchase price, it was generally not possible for the lessee to use the leased asset as collateral to secure other credit. These concerns led States to consider the first policy choice: whether a generic, comprehensive concept of an acquisition financing transaction might be a better way to organize this branch of secured transactions law.

72. Many States concluded that the legal regime would be less uncertain and would generate less litigation if it did not draw formal distinctions between the rights available to different providers of acquisition financing. That is, even when they decided that sellers should continue to be able to protect their rights by retaining ownership of the assets sold until full payment by the buyer, these States decided to simplify the design of the regime by adopting the approach that produces functionally equivalent outcomes: all transactions being used to finance the acquisition of tangible assets would be treated in essentially the same way regardless of their form and regardless of the legal status of the creditor (as seller, lessor or lender).

73. Consistent with the recommendation that States should adopt the functionally integrated approach to non-acquisition secured transactions (see recommendation 8), in this chapter the *Guide* recommends that States should adopt the functionally integrated approach in respect of all acquisition financing transactions, however denominated (see recommendation 9 and the statements of purpose preceding the recommendations in options A and B at the end of this chapter). That is, the *Guide* recommends that States should enact regimes that achieve functionally equivalent outcomes, regardless of whether they decide to adopt the unitary or the non-unitary approach to the functional equivalence of acquisition and non-acquisition financing transactions (see recommendation 178 for the unitary approach and recommendation 188 for the non-unitary approach).

(c) *Unitary and non-unitary approaches to functional equivalence*

74. The second main policy choice that confronts States concerns the manner in which they design legislation to achieve functionally equivalent outcomes. Once again, the main objective is to ensure that, in so far as possible, the legal regime that brings about this functional equivalence is crafted in a manner that facilitates the broadest extension of credit at the lowest price. This type of efficiency in a legal regime can be achieved in one of two ways.

75. First, States may choose to collapse distinctions between various forms of acquisition financing transactions and adopt a single characterization of these devices. This is the policy that the *Guide* recommends for security rights generally. This method for achieving

functionally equivalent outcomes is referred to in this chapter as the “unitary” approach to acquisition financing. All acquisition financing transactions under the unitary approach will give rise to “acquisition security rights” and all financiers will be considered as “acquisition secured creditors”.

76. Second, States may choose to retain the form of existing acquisition financing transactions and the characterization that parties give to their agreement (for example, as sale, lease or loan), subject to a competent court declaring that characterization to be a sham in a particular case. In doing so, however, States will nonetheless be required to adjust and streamline their technical rules for each transaction so as to achieve functional equivalence across the whole regime. The *Guide* refers to this method for achieving functionally equivalent outcomes as the “non-unitary” approach. Acquisition financing transactions under the non-unitary approach will give rise either to “retention-of-title rights” and “financial lease rights” where a title device is used, or to “acquisition security rights” in favour of acquisition secured creditors where a security right (whether in favour of a lender or a seller that transfers title to a buyer) is created.

77. Depending on law other than secured transactions law, the decision as to which of these approaches to adopt could have significant consequences. For example, it might affect the rights of third parties both in and outside insolvency proceedings (the issues relating to insolvency are discussed in section A.13 below and in chapter XII). In addition, having decided to adopt one or the other of these approaches, States will also have to decide exactly how to design the particular rules by which all aspects of acquisition financing transactions will be governed, and integrate these particular rules into the general law of sale and lease.

(i) *Unitary approach*

78. Three main consequences flow from a State’s decision to adopt the unitary approach. First, all acquisition financing devices, regardless of their form, will be considered as security devices and subjected to the same rules that govern non-acquisition security rights (except with respect to priority conflicts). Second, a creditor’s right in tangible assets under a retention-of-title sale, sale under resolatory condition, hire-purchase agreement, financial lease or similar transaction will be considered to be an acquisition security right and will be regulated by the same rules that would govern an acquisition security right granted to a lender. Third, the buyer in such cases will be considered to have acquired ownership of the asset, regardless of whether the seller or lessor purports to retain title by contract.

79. States may take one of two paths to enacting the unitary approach in cases where sellers use retention of title or a financial lease. They may provide that the buyer becomes the owner for all purposes, with the result that States would explicitly have to amend other legislation (such as taxation statutes if they desired that sellers in such transactions should be taxed as owners). Alternatively, they might provide that buyers become owners only for the purposes of secured transactions law and its related fields (debtor-creditor law and insolvency law in particular). It is important to note, however, that coherence of the regime requires States to take the same path in relation to acquisition financing transactions that they take in relation to non-acquisition financing transactions.

(ii) *Non-unitary approach*

80. As the *Guide* adopts a unitary approach to non-acquisition financing, traditional lender transactions such as sales with a right of redemption, sales with a leaseback and fiduciary transfers of title are all considered to be ordinary security rights. Only in relation to seller transactions (and “seller-like” transactions such as financial leases) does the *Guide* contemplate the possibility of a non-unitary approach. That said, even when States adopt a non-unitary approach to acquisition financing transactions, they should design the regime to reflect the functional equivalence principle (see recommendation 188). For example, the regime should treat all the following providers of acquisition financing in a functionally equivalent manner: sellers that retain title; sellers that do not retain title but retain a right to cancel the sale; sellers that do not retain title but take a regular acquisition security right in the assets sold; lessors that retain title; and lenders that take a regular acquisition security right in the assets sold or leased.

81. In principle, States that adopt the non-unitary approach could achieve functional equivalence between the rights of sellers that retain title and financial lessors, on the one hand, and the rights of acquisition secured creditors, on the other, in one of two ways. They could: (a) model the rights accorded to retention-of-title and similar claimants on those given to acquisition secured creditors that are not sellers or lessors; or (b) they could model the rights of these other acquisition secured creditors on the rights already available to retention-of-title creditors. In the former case, all acquisition financiers would be treated the same (that is, as acquisition secured creditors), but acquisition financiers that retain ownership would have slightly different rights from ordinary owners. In the latter case, all acquisition financiers and acquisition secured creditors would be treated the same (that is, as owners), but acquisition secured creditors and non-acquisition secured creditors would be subject to slightly different rules. While formally these may appear to be equally viable options, in view of the overall objective of enabling parties to obtain secured credit in a simple and efficient manner, there are several reasons why the former approach to achieving functional equivalence in a non-unitary regime should be preferred.

82. The question for States is what approach is more likely to promote transparent and lowest-cost credit, regardless of the source of the credit. First, it would be quite complicated to design a set of rules that would treat lenders as owners (especially since lenders normally have no expertise in selling or maintaining the assets they are financing). Second, even though these lenders would be characterized as owners, their ownership would not be identical to ordinary ownership since their enforcement rights would be adjusted to protect the rights of certain third parties that may have taken security in the buyer’s expectancy right. Third, it would be quite complicated to design a set of rules that distinguish between the accessory rights afforded to two classes of lenders, namely ordinary secured lenders and acquisition secured lenders. Fourth, it is much simpler to model the rights and obligations of a seller that benefits from an acquisition financing right (for example, in relation to its creation, effectiveness against third parties, priority over competing claimants and enforcement) on those of a seller or lender that benefits from an acquisition security right (an acquisition secured creditor). The reason is that this approach would enhance the overall coherence of the secured transactions regime, while enabling States to make adjustments necessary to maintain the coherence of their regime of ownership as reflected in the law of sale and lease. For these reasons, the *Guide* recommends that States choosing to adopt a non-unitary approach to acquisition financing transactions should

seek to achieve functional equivalence by modelling retention-of-title rights and financial lease rights on acquisition security rights, rather than the reverse (see recommendation 188). Regardless of which of these two approaches a State adopts, it will be necessary for that State to modify its existing regime of retention-of-title rights and financial lease rights as indicated in this chapter in order to achieve functional equivalence.

(iii) *Comparing the two approaches*

83. The *Guide* recommends that States should adopt the unitary approach to achieving functional equivalence of acquisition financing to non-acquisition financing transactions. Given this general orientation, the *Guide* suggests that, to the extent that they have the opportunity to do so, States should also adopt the unitary approach to achieving functional equivalence among all acquisition financing mechanisms. Notwithstanding this suggestion, however, the *Guide* acknowledges that some States may feel the need to retain the form of title devices to govern the rights of sellers, financial lessors and other suppliers (see recommendation 9). For this reason, in each of the following subsections of this chapter (A.6-A.13), the relevant issues are examined as they arise in contemporary legal systems. Each subsection concludes with a review of how the law of acquisition financing could be best reformed if one or the other of these approaches (unitary or non-unitary) to achieving functional equivalence were adopted.

84. Parallel recommendations are presented as option A and option B. Option A presents recommendations about how States should design the detail of a functionally integrated and unitary approach to acquisition financing transactions. States that are enacting legislation to govern the full range of secured transactions for the first time will find option A easier to implement, although States with a comprehensive secured transactions regime can certainly benefit from this approach as well. Option B deals with how States that elect to retain a non-unitary approach should design rules governing acquisition financing through title devices and, in particular, retention-of-title and financial lease transactions, as well as acquisition security rights, so that the economic advantages of a functionally integrated regime may be equally achieved under a non-unitary approach.

6. *Creation (effectiveness as between the parties)*

85. In chapter II on the creation of a security right, the *Guide* discusses the requirements for making a security right effective as between the grantor and the secured creditor. As explained in that chapter, the underlying policy is to make the requirements for achieving effectiveness between the parties as simple as possible (see chapter II on the creation of a security right, para. 6; see also recommendation 1, subparagraph (c)). The precise manner in which these requirements may be transposed to regulating the effectiveness of the rights flowing from an acquisition financing transaction as between the parties will depend on whether a State adopts the unitary or non-unitary approach. In States that continue to recognize retention-of-title transactions and financial leases as distinct security devices, it is, moreover, not obvious that the word “creation” is the most appropriate one to describe how the seller under a retention-of-title transaction and the lessor under a financial lease “acquire” their rights. For example, the seller that retains ownership is not “creating” a new right in its favour; it is merely continuing to assert the right of ownership that it had prior to entering

into the agreement with the buyer. Likewise, the lessor's ownership rights are not "created" by the contract of lease; the lessor is already the owner at the time it enters into the lease agreement with the lessee. Nonetheless, for ease of expression, the agreements under which a seller and a lessor may continue to assert their ownership against a buyer or lessee to whom they have granted possession of a tangible asset will sometimes be described as agreements "creating" the acquisition financing rights in question. Of course, it may be argued that, in those States where the buyer under a retention-of-title agreement acquires an expectancy of ownership, a new type of bifurcated ownership is created. Under such an analysis, it is appropriate to speak of the "creation" of a retention-of-title right since the ownership right that remains with the seller is not exactly traditional ownership.

86. States that do not treat all acquisition financing transactions in the same way impose widely varying requirements for making acquisition rights effective as between the parties. To begin with, the requirements imposed may vary within each State depending on the specific type of acquisition financing transaction (retention of title, financial lease, security right) in question. In addition, they can vary widely among different States even in respect of the same type of acquisition financing transaction. That is, not all States conceive of retention-of-title rights and financial lease rights identically and, therefore, not all impose the same requirement for creating or reserving such a right.

87. As an acquisition financing right, retention of title is usually seen as a property right that arises by virtue of one of the clauses in the contract of sale. It follows that, in many States, the formal requirements for the creation of a retention-of-title right are those applicable to contracts of sale generally, with no particular additional formalities required. Hence, if a State accepts that a contract for the sale of tangible assets may be concluded orally, the clause of the agreement providing that the seller retains ownership until full payment of the purchase price might also be oral. In such cases, the seller's retention-of-title right may be agreed to orally, or by reference to correspondence between the parties, a purchase order or an invoice with printed general terms and conditions. These documents may not even bear the signature of the buyer, but the buyer may implicitly accept the terms and conditions they set out through the taking of delivery of the assets and payment of part of the purchase price as indicated, for example, in the purchase order or invoice. In other States, even though a regular contract of sale may be concluded orally, a writing (even if minimal), a date certain, notarization or even registration may be required for a retention-of-title clause in a contract of sale to be effective even as between the parties.

88. Credit providers that use financial leases, hire-purchase agreements and related types of transaction also retain ownership because of the nature of those contracts. The effectiveness of, for example, the lessor's right as between the parties will be dependent upon the parties complying with the ordinary formalities applicable to the particular financial lease or hire-purchase agreement in question.

89. In most States, only the actual seller or financial lessor may benefit from a retention-of-title right or a financial lease right and be required to follow the formalities associated therewith. Other providers of acquisition financing, such as lenders, may not directly obtain either a retention-of-title right or a financial lease right. Rather, to do so, they must receive an assignment of the contract of sale from the seller or an assignment of the contract of lease from the lessor. Thus, the formalities for effectiveness of such a right claimed

by a lender are, first, those applicable to the initial transaction with the buyer or lessee, and second, those applicable to an assignment of that type of contract.

90. In many States that permit separate retention-of-title rights and financial lease rights, it is also possible for sellers, lessors and lenders that provide acquisition financing to take a security right in the asset being purchased or leased. These States typically vest the seller that takes such a security right with a priority right equivalent to the right of a seller. However, they do not permit lenders that provide acquisition financing to claim the preferred rights of a seller that either retains title or takes a security right in the asset being purchased.

91. The various States that do not treat sales with a retention-of-title clause or financial leases as security rights also take differing approaches to the extension of these rights into other assets. In some States, if assets subject to retention of title are commingled with other assets, the retention-of-title right is extinguished. In a few States, by contrast, the retention-of-title right continues to be effective as between the parties; in these States, by exception to general principles of property law, as long as similar assets are found in the hands of the buyer, the seller need not undertake any further formality to preserve its right of ownership. Similarly, in most States, the retention-of-title right cannot be extended to assets that are processed or manufactured into new products, while in a small number of other States, the retention-of-title right is automatically preserved when the assets are manufactured into a new product. In some States that take the latter approach, the seller is entitled automatically to claim its retention-of-title right in the new product, while in other States the seller simply becomes an ordinary secured creditor, without the special priority that could be claimed by a retention-of-title seller. Some States also permit lessors to continue to claim ownership of leased assets that have been slightly modified or, depending on the terms of the lease, of the proceeds of an authorized disposition. In these cases as well, no additional steps are typically required in order to preserve effectiveness of the security right as between the parties in the modified assets or the proceeds.

92. There is a greater similarity in the principles governing the requirements for effectiveness of acquisition security rights as between the parties among the various States that have adopted a fully integrated approach. Indeed, almost no differences in these requirements may be found. Moreover, within each State, the formal requirements for making an acquisition security right effective as between the parties are identical, regardless of whether the financing is provided by a seller, a financial lessor, a lender or any other person. In addition, because acquisition secured credit is treated simply as a special category of security right, these formal requirements will be the same relatively minimal formalities as those required for non-acquisition secured transactions. As already mentioned (see chapter II on the creation of security right, paras. 26-29), these formalities are simply a written and signed agreement identifying the parties and reasonably describing the assets sold and their price, or an oral agreement accompanied by the transfer of possession of the assets to the secured creditor (see recommendations 13-15). Finally, because the acquisition security right is a security right, it will be automatically preserved in attachments, manufactured assets and in proceeds of disposition (see recommendations 19-22).

93. The difference between the two approaches and among the specific legal systems described above rarely lies in the writing requirement. That is, most of them would accept correspondence, an invoice, a purchase order or the like with general terms and

conditions, whether they are in paper or electronic form, as satisfying the written form requirement. This is, moreover, the general position concerning a writing requirement that is recommended by the *Guide* (see recommendations 11 and 12). The difference seems to lie more in whether a signature is required for effectiveness as between the parties. In some States the buyer's signature is not necessary as long as the retention-of-title seller, acquisition secured creditor or financial lessor is able to demonstrate by other evidence that the buyer or financial lessee has accepted the terms of the agreement. Such evidence could consist merely of the buyer's or financial lessee's acquisition and use of the assets without protest after having received the writing. In addition, because so many transactions for the purchase of tangible assets are in fact well documented for other reasons, this issue rarely arises.

94. Under the unitary approach, the requirements for effectiveness as between the parties are the same as those applicable to non-acquisition security rights, regardless of the legal form of the transaction (see recommendation 178).

95. If a non-unitary approach were adopted, States seeking to achieve the benefits of a regime that created equal competition for credit would have to develop a regime for creation of an acquisition security right that permits lenders to acquire the same preferred status as that given to retention-of-title sellers and financial lessors. To achieve this result, these States would have to ensure that the rules governing effectiveness as between the parties would be functionally equivalent, regardless of the form of the acquisition financing transaction (see recommendation 188). In particular, the rules governing: (a) the capacity of parties to the contract; (b) the specific character and modalities of the obligation secured; (c) the assets in which the acquisition financing right might be taken; (d) evidentiary obligations such as a writing and signature; and (e) the time of effectiveness of the agreement between the parties would have to be closely coordinated so as not to favour one type of acquisition financing transaction over another.

7. *Effectiveness against third parties*

(a) *General*

96. The *Guide* draws a distinction between effectiveness of a security right as between the grantor and the secured creditor and effectiveness of that right as against third parties (see chapter II on the creation of a security right, paras. 1-7, and chapter III on the effectiveness of a security right against third parties, paras. 6-8). The point has particular importance in relation to acquisition financing rights since, depending on whether a unitary or non-unitary approach is followed, the distinction between these types of effectiveness may not actually exist.

97. Most States that do not treat retention-of-title rights and financial lease rights as security rights do not require these transactions to be registered. Nor do they require the seller or the lessor to take any other formal step beyond what is necessary to make the right effective between the parties in order to ensure its effectiveness as against third parties. To the contrary, in these States, when the seller and buyer enter into a retention-of-title agreement, the seller's ownership right in the tangible assets that have been sold is effective as against all parties.

98. In some States, by contrast, registration of a retention-of-title right or a financial lease right is required either generally or for particular types of tangible asset. In these States, it is often the case that registration is required only to make the seller's retention-of-title right or financial lease right effective as against third parties. Sometimes, however, no distinction is drawn between effectiveness of the retention-of-title right or a financial lease right as between the parties and its effectiveness as against third parties. That is, in some States registration of these rights is viewed as a requirement for effectiveness even as between the parties.

99. Under all of these retention-of-title regimes, the seller retains ownership of the assets sold and delivered to the buyer. As a consequence, it will usually be the case that the buyer has no property rights in the assets being purchased until title passes, usually when the purchase price is paid in full. This means that, except in those legal systems in which the buyer has an ownership expectancy right that the buyer may encumber, no other creditor of the buyer is able to claim rights in the tangible assets being purchased as long as the seller retains ownership. This would be the case even if another creditor provided credit to the buyer to purchase the asset and the value of the buyer's asset subject to the retention-of-title right was higher than the amount of the purchase price still owed to the seller. In such cases, the only asset of the buyer upon which another creditor could claim a security right would be an intangible asset (the right of the buyer to the value of the purchase price paid). An identical outcome would also result in the case of a financial lease. Unless the lease provides for a right of the lessee to buy the leased asset at the end of the lease and thus gives the lessee an ownership expectancy right that the lessee may encumber, the sole asset of the lessee upon which the lessee's creditors could claim security rights would be an intangible asset (the right of the lessee to the use of the leased asset for the remainder of the lease term).

100. In States that do not recognize the right of a buyer that acquires assets under a retention-of-title transaction or of a lessee under a financial lease to grant a security right in the assets purchased or leased, this non-recognition either prevents or makes it difficult for borrowers to use the full value of the equity they may have acquired in their tangible assets subject to retention-of-title rights or financial lease rights. That is, the conceptual logic of a retention-of-title agreement or a financial lease agreement precludes the buyer from granting a non-possessory security right in the assets being acquired or leased. Interestingly, however, these same States generally permit a purchaser to grant multiple encumbrances on immovable property (mortgages, hypothecs or other encumbrances) with priority based on time of registration, even when the immovable property has been sold under a retention-of-title transaction and the purchase price has not yet been paid in full. In States that now follow a fully integrated approach, retention of title and its economic equivalents are subject to registration of a notice in the general security rights registry or to some other formality for making the right effective against third parties in the same way as any other security right. Under this approach, moreover, the right of the seller that retains ownership by contract, or of the lessor that remains owner by virtue of the nature of the lease, is transformed into the right of an acquisition secured creditor. As a result, the buyer or lessee is able to use the equity it has in the assets being purchased or leased as security for further credit. That is, in these States, the right of the retention-of-title seller or financial lessor that is made effective against third parties is not a right of ownership. It is, rather, a security right with the same third-party effectiveness as arises in the case of a seller that sells the tangible assets outright and takes a security right in the assets sold.

101. Under the unitary approach, the requirements for third-party effectiveness (except in respect of the acquisition of consumer goods; see recommendation 179 and paras. 112-115 below) are the same as those applicable to non-acquisition security rights and are identical regardless of the legal form of the transaction (see recommendation 178).

102. If a non-unitary approach were adopted, States would have to ensure that no substantial differences in requirements for third-party effectiveness exist between the different kinds of acquisition financing transactions (see recommendations 188 and 192). A number of rules would have to be closely coordinated so as not to favour one form of transaction over another and, in particular, the rules governing: (a) the modalities by which third-party effectiveness can be achieved; (b) the timing of third-party effectiveness when requirements are met; (c) the consequences of third-party effectiveness for the right of the buyer or lessee to grant rights in the assets; and (d) the regime governing consumer goods. Specifically, in order to maximize the buyer's or lessee's capacity to benefit from the tangible assets being acquired in the non-unitary approach, States would have to provide that they have the power to grant a security right in the assets subject to the retention-of-title or financial lease right (see recommendation 190).

(b) Third-party effectiveness of acquisition financing transactions generally

103. As already noted (see chapter III on the effectiveness of a security right against third parties, paras. 29-46), the general mechanism by which ordinary security rights may be made effective against third parties is registration (see recommendation 32). As is the case with the registration of a non-acquisition security right, registration of an acquisition security right is meant to provide a notice to third parties that such a right might exist and to serve as a basis for establishing priority between a secured creditor and a competing claimant. Generally, registration promotes credit market competition by providing information that enables financiers to better assess their risks.

104. For this reason, the *Guide* recommends that third-party effectiveness of all types of acquisition financing transaction should usually be dependent on the registration of a notice in the general security rights registry. Where the *Guide* also recommends other mechanisms to achieve third-party effectiveness for ordinary security rights (for example, possession, registration in a specialized registry, notation on a title certificate), these mechanisms should be available as alternative means to achieve third-party effectiveness of acquisition security rights (see recommendations 178 and 188).

105. Under the unitary approach, coordination of the registration of notices relating to acquisition and non-acquisition security rights in the general security rights registry will be necessary to promote certainty in the relative priority of competing claimants (for a discussion of priority in relation to acquisition financing see paras. 116-182 below and recommendations 180-185). In order to achieve the greatest efficiency, it is generally necessary for existing financiers that propose to make disbursements in the future to know whether an acquisition security right is being claimed by another secured creditor. Sometimes this occurs because the creditor claiming an acquisition security right must notify existing secured creditors prior to delivery (see recommendation 180, alternative A, subparagraph (b)(ii)b), in the case of inventory). Sometimes however, it is not necessary to notify existing secured creditors (see recommendation 180, alternative A, in the case of

tangible assets other than inventory or consumer goods, and recommendation 180, alternative B in the case of all tangible assets other than consumer goods). In these cases, and particularly where alternative B of recommendation 180 is adopted, States may wish to consider requiring creditors that claim an acquisition security right to indicate in the notice being registered in the general security rights registry that they are claiming an acquisition security right.

106. Under the non-unitary approach, the rules governing the registration of a notice with respect to retention-of-title rights, financial lease rights and acquisition security rights will also have to be coordinated with the general rules relating to the registration of a notice with respect to security rights. Doing so requires either adjusting the rules relating to retention-of-title rights and financial lease rights to cohere with the rules governing registration of security rights generally or, less plausibly, adjusting the rules governing security rights generally to cohere with the rules relating to registration of retention-of-title rights and financial lease rights, and establishing a general security rights registry in which notices relating to all such rights can be registered. Together, these steps will ensure certainty in the relative priority of competing claimants that hold different types of acquisition financing right (see paras. 116-182 below and recommendations 191-193, 195 and 198). Moreover, in the case where a creditor is claiming a retention-of-title right or a financial lease right, it will always be apparent to other creditors from the use of the terms “retention-of-title” or “financial lease” that the right in question is being claimed in relation the acquisition of a tangible asset, regardless of whether a State chooses alternative A or alternative B of recommendation 192. Finally, should a creditor under the non-unitary approach be claiming a regular acquisition security right, the recommendations relating to the content of the notice of an acquisition security right under the unitary approach (recommendation 180, alternative A and alternative B) would be applicable (see recommendation 187, subparagraph (a)). In these cases, and particularly where alternative B of recommendation 180 is adopted, States may, in a like manner, wish to consider requiring creditors that claim an acquisition security right to indicate in the notice being registered in the general security rights registry that they are claiming an acquisition security right.

107. The principles that should govern what kinds of conflict are to be considered priority conflicts under the unitary approach, including priority conflicts where different methods for achieving third-party effectiveness have been used (see recommendations 180-185), and what are often questions of third-party effectiveness under the non-unitary approach (see recommendations 191-193, 195 and 198) are discussed below in section A.8.

(c) *Grace period for the registration of certain acquisition financing transactions*

108. Many States historically did not require sellers to take further steps to make their rights effective as against third parties. Similarly, where a seller retained title, it was typically not necessary to register the retention-of-title right. By contrast, and in keeping with the approach adopted by most States that have recently modernized their secured transactions laws, the *Guide* recommends that registration or some other step should be taken by sellers, financial lessors or lenders providing acquisition financing in order to achieve third-party effectiveness (see recommendations 178 and 192).

109. Where States require registration in the acquisition financing context, most seek to enhance the efficiency of the registration process by providing sellers and other providers of acquisition financing with a short grace period (for example, 20 or 30 days) after delivery of the assets sold or leased to register a notice relating to the acquisition financing transaction in question. Such grace periods are found both in States that do not consider retention-of-title rights and financial lease rights to be security rights and in systems that consider all such rights to be acquisition security rights. Among other advantages, the use of the grace period facilitates the efficient flow of tangible assets by permitting sellers to deliver assets to the buyer without having to wait until they or any other provider of acquisition financing registers a notice.

110. Under the unitary approach, if the notice is registered within the grace period, the right of an acquisition secured creditor in assets other than inventory has the same priority in relation to other claimants that that creditor would have been able to assert had it registered the right at or before the time of delivery. This rule may be limited to assets other than inventory, because, in the case of inventory, registration and notification of inventory financiers on record has to take place before delivery of the tangible assets in order to protect pre-existing non-acquisition secured creditors (see recommendation 180, alternatives A and B).

111. If a State were to adopt the non-unitary approach, the same rules relating to a grace period for registration and its effects should apply to all acquisition financing transactions regardless of the legal form of the transaction (see recommendation 192, alternatives A and B).

(d) Exceptions to registration for consumer transactions

112. In some States where the registration of a notice relating to acquisition financing transactions would otherwise be required, an exception is made when those transactions relate to consumer goods. This means that the seller or other provider of acquisition financing relating to tangible assets bought for the buyer's personal, household or family purposes is not burdened with a requirement to register; nor, as a rule, is the seller or credit provider in these cases required to follow any of the other steps by which third-party effectiveness is normally achieved. Such transactions become effective against third parties at the same time that they become effective as between the parties. The idea is that in such cases the need to warn potential third-party financiers is less acute, especially where the consumer goods are of low value. In other legal systems that generally require registration, only relatively low-value consumer transactions are exempted from the requirement to register (for example, consumer transactions up to a maximum of € 3,000 or its equivalent, or transactions that are subject to the jurisdiction of small claims courts).

113. In both types of system, the significant market involving automobile finance credit to consumers is usually served by a system that requires registration not in the general security rights registry but rather in a specialized registry, or that requires a notation on a title certificate. Moreover, it is important to note that, in States that create an exemption from registration for consumer goods, the exception applies only to consumer transactions. In other words, the exception does not apply to a particular type of asset as such (that is, consumer goods), but rather only to a type of transaction relating to those assets (that is, the

sale of tangible assets to a buyer for personal, household or family purposes). It is still necessary to register a notice to achieve third-party effectiveness in assets normally sold to consumers if those assets are being sold to a wholesaler or a retailer as inventory.

114. The exemption from registration applies to tangible assets bought on credit for the buyer's personal, family or household purposes. Nonetheless, if a grace period were adopted for registering the notice of an acquisition financing transaction relating to equipment in the general security rights registry, that grace period may, in itself, serve as the equivalent of an exemption for short-term credit transactions fully paid within the grace period because, as a practical matter, the acquisition financier would not have to register before the expiry of that period. As for equipment-related acquisition financing transactions with longer repayment periods, and inventory-related transactions in general, an exemption may not be necessary if the acquisition financier was entitled to register a single notice in the secured transactions registry for a series of short-term transactions occurring over a longer period of time (for example, five years) (see recommendations 178 and 193). These issues are fully discussed below in section A.8.

115. Under the unitary approach, the exemption from registration (or other method for achieving third-party effectiveness) for consumer transactions would apply regardless of whether the acquisition secured creditor were a seller, lessor or lender since they would all be claiming identical rights. Were a non-unitary approach to be adopted, the rules relating to the exemption from registration (or other method for achieving third-party effectiveness) for transactions relating to consumer goods should produce the same consequences regardless of the legal form of the transaction (see recommendations 179 and 191).

8. Priority

(a) General

116. The *Guide* adopts the term "priority" to deal with competitions between a secured creditor and any other person that may have rights in assets subject to a security right. The concept of priority thus includes competitions of an acquisition secured creditor both with other creditors (including secured creditors, whether or not acquisition secured creditors, creditors that may avail themselves of a statutory preference and judgement creditors) and other claimants (including prior owners, buyers, lessees, licensees and the insolvency representative). Nevertheless, some States, and especially some States among those that do not consider retention-of-title rights and financial lease rights to be acquisition security rights, adopt a more restrictive view of the notion of priority. Only competitions between a secured creditor and another creditor are considered to involve priority claims. Other potential conflicts (notably those involving prior owners and subsequent purchasers) are resolved by reference to the right of ownership. This said, however the competition between various potential claimants is characterized, the relative rights of each must be carefully specified.

(b) Priority position of providers of acquisition financing

117. The *Guide* recommends in chapter II on the creation of a security right that a creditor may obtain an ordinary security right in both present and future assets (see recommendation 13).

It also recommends in chapter V that priority should generally be determined by the date of registration of a notice with respect to a security right, even in relation to future assets (see recommendations 76 and 99). As a consequence, in order to promote the extension of new credit for the acquisition of assets, it is necessary to establish special rules applicable to competitions between retention-of-title sellers, financial lessors and acquisition secured creditors on the one hand, and pre-existing non-acquisition secured creditors holding rights in future assets of the grantor on the other.

118. In States that do not treat retention-of-title rights and financial lease rights as security rights, the relative priority of rights is decided by reference to the seller's or lessor's right of ownership. The retention-of-title seller or financial lessor effectively prevails with respect to the assets sold over all other competing claimants whose rights derive from the buyer or lessee (except certain good faith buyers). Moreover, in most such systems, until the buyer or lessee acquires title to the assets, by fully paying the purchase price or, in certain cases, by making the last lease payment, none of the buyer's or lessee's other creditors are able to claim rights in the assets being purchased or subject to the lease. In particular, neither a secured creditor with a security right in future assets nor a lender that has provided acquisition financing can claim a security right in the assets being purchased. At best, these secured creditors can claim a right in the value paid by the buyer or lessee, provided they have included that type of intangible asset in the description of the assets covered in the notice that they have registered. Similarly, judgement creditors and the insolvency representative may assert the buyer's or lessee's rights, but unless the legal system permits the buyer or financial lessee to transfer or encumber its expectancy right, neither they nor secured creditors can seize the asset itself.

119. Finally, in most such States, there can never be a competition between lenders claiming as a provider of acquisition financing and a retention-of-title seller or financial lessor. First, for reasons given above, the buyer or lessee has no assets in which the lender could actually assert an acquisition security right. Second, it is rarely the case that the lender could acquire the expectancy right of the buyer or lessee (for example, by taking a conditional assignment of the right subject to an obligation to retransfer it to the buyer or lessee when the loan is paid in full); and even if the lender could take such a right, the right would normally be seen as a type of pledge, or sale with a right of redemption, and not as a right arising in an acquisition financing transaction. Were a legal system to permit such transactions, the lender that acquired the ownership expectancy right would have a right that could be set up as against any other claimants asserting rights derived from the buyer or lessee, including buyers, secured creditors, judgement creditors and the insolvency representative. However, this right would always be subordinate to the ownership rights of the retention-of-title seller or financial lessor. In other words, in these legal systems, the primary way in which a lender could acquire a preferred status as against other creditors and claimants would be to purchase the seller's or lessor's retention-of-title or financial lease right.

120. In States that follow the fully integrated approach, the priority rights of a seller or a lessor that provides acquisition financing are equally protected. Provided that the retention-of-title seller, financial lessor or similar title claimant registers a notice in the general security rights registry within a short period of time after the delivery of the assets and, in the case of inventory, takes certain other steps discussed below, it will have priority over all other claimants (except certain good faith buyers). Moreover, in these States, a lender that provides financing to enable a buyer to purchase assets will also be an acquisition

secured creditor with priority over other claimants in the same manner as a seller or lessor. This means that, unlike the situation in States that do not follow the fully integrated approach, there can be more than one creditor claiming an acquisition security right. As a consequence, under the fully integrated approach, a further priority rule is necessary to deal with these cases. Invariably, these States provide that the seller that purports to retain title, the financial lessor and the seller that transfers title but takes an ordinary acquisition security right will have priority over any other provider of acquisition financing, such as a bank, even if that other financier had made its acquisition security right effective against third parties before the seller or lessor did so. Thus, in States that follow the fully integrated approach, the seller and lessor are able to achieve the same preferred priority position in relation to all other claimants as the retention-of-title seller or financial lessor in systems that do not treat these transactions as secured transactions.

121. While rights under acquisition financing transactions will normally be made effective against third parties by registration in the general security rights registry, many States also contemplate other methods for achieving third-party effectiveness. In these States, one such method (that is, possession by the secured creditor) will generally produce the same consequences as registration, and may be looked upon as an alternative to registration. As a result, should a provider of acquisition financing such as a retention-of-title seller, a financial lessor or a seller that takes an acquisition security right make its rights effective against third parties by possession within the stipulated grace period, the general priority principle would be applicable. Given the purposes of acquisition financing, the idea of the acquisition financier retaining possession is, of course, highly implausible but theoretically possible. Where States also permit lenders to obtain acquisition security rights, an identical outcome would result.

122. Where the non-acquisition secured creditor makes its security right effective against third parties by registration in a specialized registry, States typically provide that the registration in the specialized registry will give the registering creditor priority even over prior registrations in the general security rights registry or third-party effectiveness achieved by a prior possession. In order to enhance the usefulness of the specialized registries, these States adopt a similar rule in relation to providers of acquisition financing. By implication, it would follow that an acquisition security right that is registered in the specialized registry would not have priority over a prior non-acquisition security right registered in that specialized registry.

123. Under the unitary approach of the *Guide*, all acquisition secured creditors, whether sellers, lessors or lenders, are subject to the same priority regime and must take identical steps in order to assure their priority position (see recommendation 178). Having done so, they are entitled to claim priority even over pre-existing creditors that have non-acquisition security rights in the grantor's future assets. Because the acquisition security right is not subject to the general rule that fixes priority based on the time of registration, this preferred position of an acquisition security right is often referred to as a "super-priority". In a competition between acquisition secured creditors that have all taken the necessary steps to make their rights effective against third parties, the time of registration will generally determine their relative priority under the same principles as apply to non-acquisition security rights (see recommendations 178 and 180). The only difference between different categories of acquisition secured creditors is that in a competition between a supplier (seller or a lessor) and another creditor, all of whom are asserting an acquisition security

right, the supplier would always have priority, regardless of the respective dates of registration of their rights (see recommendation 182). Where a security right is made effective against third parties by registration in a specialized registry or notation on a title certificate, the registration in the specialized registry or notation will, nonetheless, give the registering creditor priority over providers of acquisition financing that have registered in the general security rights registry or taken possession within the grace period (see recommendation 181). While it could be possible to provide that an acquisition security right that is registered in the specialized registry would have priority even over a prior non-acquisition security right registered in that specialized registry, in order to avoid any interference with these registries, the *Guide* makes no recommendation on this point and leaves the matter to other law.

124. If the non-unitary approach were adopted to achieve functional equivalence, States would likely have to make slight adjustments to their existing regimes. First, it would be necessary to permit providers of acquisition financing, other than retention-of-title sellers and financial lessors, to acquire the preferred priority status of sellers and lessors by taking an acquisition security right. In such cases, it is important that equivalent rules relating to the priority of the seller's or lessor's rights be established regardless of the legal form of the transaction (see recommendations 187 and 188). Second, and concomitantly, in a competition between a retention-of-title seller, financial lessor or seller that obtains an acquisition security right, on the one hand, and a provider of acquisition financing that is not a seller or lessor, on the other hand, it would be necessary to ensure that priority goes to the seller or lessor, regardless of the time at which a notice of these various acquisition financing rights and acquisition security rights was registered (see recommendations 187, subparagraph (a), and 192). This will follow as a matter of course in cases involving a seller that retains title or a financial lessor, but where the seller transfers title to the buyer and obtains an acquisition security right, it would be necessary to specify that the seller's acquisition security right will always have priority over any other acquisition security right. In so far as specialized registries are concerned, it will be the retention-of-title seller or financial lessor that is registered as the owner in the specialized registry. No other creditor of the buyer or lessor can register a security right in that registry, so the seller or lessor will achieve priority simply by virtue of its registered ownership right. Only in cases where the seller transfers title to the buyer and takes an acquisition security right would the principle relating to the priority of registration in specialized registries be applicable.

(c) *Priority of acquisition financing rights in consumer goods*

125. The general priority principles just noted establish a framework for organizing the rights of providers of acquisition financing where more than one of them may be in competition over the same tangible asset. However, not all tangible assets serve the same economic purpose and are subject to the same business dealings. Consequently, many States have drawn distinctions between types of such asset (notably, between equipment and inventory, but often between commercial assets and consumer goods as well) in the non-acquisition financing context. For example, in some States, different denominated security devices are available depending on the type of asset (for example, an agricultural or commercial pledge for equipment, a transfer of or a floating charge in inventory). In States with fully integrated systems involving a generic concept of a security right, these different types of security device have disappeared. However, even in such States,

the distinctions between different types of asset remain where acquisition security rights are an issue. Thus, it is instructive to examine how States have addressed acquisition financing in relation to different categories of asset.

126. Whether or not they have adopted a fully integrated approach to secured transactions security rights, many States provide for special rules in relation to consumer goods. By exception to the general principle, in these States, the rights of providers of acquisition financing for consumer goods are effective against third parties without registration in the general security rights registry or creditor possession. As a result, the relevant time for fixing effectiveness against third parties is the time when the agreement was effective between the seller and the buyer, the lessor and the lessee or the lender and the borrower, as the case may be. Consequently, the priority of an acquisition security right, a retention-of-title right or a financial lease right over any non-acquisition security right created by the buyer, lessee or borrower should be acquired automatically from the time the right becomes effective as between the parties.

127. Under the unitary approach of the *Guide*, providers of acquisition financing for consumer goods are able to claim priority over non-acquisition secured creditors without the need to make the right effective against third parties by registration or possession. Except where the consumer goods are subject to registration in a specialized registry or notation on a title certificate, the priority position of an acquisition financier is acquired upon creation of the acquisition security right (see recommendation 179).

128. States that adopt a non-unitary approach would have to provide equivalent rules giving priority to the seller's or lessor's rights over security rights that a purchaser of consumer goods may have previously granted in future assets, without the need to make the rights effective against third parties by registration or possession. This priority could find its source either in the retention-of-title seller's or financial lessor's ownership, or in the case of a seller or lender that takes an acquisition security right, in the general principle that applies to acquisition security rights in consumer goods (see recommendation 191).

(d) Priority of acquisition financing rights in tangible assets other than inventory or consumer goods

129. In most States that do not consider retention-of-title and financial lease rights to be security rights, the issue of competition among providers of acquisition financing and between providers of acquisition and non-acquisition financing does not normally arise. Pre-existing non-acquisition secured creditors are rarely permitted to acquire rights in assets of which the grantor is not yet the owner, and other lenders are generally not entitled to claim a special priority when they finance a buyer's acquisition of tangible assets. Even where it is possible to take a security right in the expectancy of ownership, that expectancy will only mature once the seller or lessor is paid in full. Only at this point can there be real competition between claimants such as secured creditors, judgement creditors, the insolvency representative, sub-purchasers and sub-lessees that derive their rights from the buyer or lessee. Where, however, the seller itself obtains an acquisition security right rather than retaining title and is in competition with a pre-existing non-acquisition security right, it is necessary to provide rules to determine when the seller's acquisition security right will have priority. Where equipment is involved, there is typically a single

asset or at most a relatively small number of individually identifiable assets being sold or leased. Moreover, these assets are normally not meant to be resold in the short term. For this reason most States do not require retention-of-title sellers or financial lessors of equipment to take any further steps beyond those necessary to achieve third-party effectiveness as a condition to asserting their ownership.

130. In States that follow a fully integrated approach, all acquisition secured creditors are required to take exactly the same steps in order to claim their special priority. Upon registration, before or within a grace period after delivery of equipment to the grantor, the acquisition security right in the new equipment is given priority over pre-existing security rights in future equipment of the grantor. Moreover, in these States as well, because equipment financing usually involves a single asset (or a relatively small number of individually identifiable assets) not normally meant to be resold in the short term, acquisition secured creditors are typically not required to take any further steps beyond those necessary to achieve third-party effectiveness as a condition to asserting their acquisition security right.

131. Under the unitary approach of the *Guide*, all acquisition secured creditors of equipment are able to claim priority over non-acquisition secured creditors for their acquisition security right, provided that they register a notice in the general security rights registry within the stipulated grace period (see recommendation 180, alternative A, paragraph (a), and alternative B).

132. States that adopt the non-unitary approach would have to provide equivalent rules relating to the priority of the seller's or lessor's rights over pre-existing rights in future equipment regardless of the legal form of the transaction. That is, even though the buyer or lessee is authorized to grant a security right in equipment over which it will only have an expectancy right until the purchase price is fully paid or the financial lease agreement comes to an end, and even if that security right covers future equipment and is made effective against third parties prior to the date of the sale, the retention-of-title seller or financial lessor will have priority if it registers a notice of its rights within the same grace period given to an acquisition financier. Similarly, under this approach, a seller that transfers title but retains an acquisition security right, or a lender that provides acquisition financing and obtains an acquisition security right, will also have priority if it registers a notice within the indicated grace period (see recommendation 192, alternative A, paragraph (a), and alternative B).

(e) *Priority of acquisition financing rights in inventory*

133. Frequently, the competition between the rights of a provider of acquisition financing and a non-acquisition security right arises in relation to inventory. In such cases, policy considerations different from those applicable to the acquisition of equipment are at issue. Unlike equipment financiers, inventory financiers typically extend credit in reliance upon a pool of existing or future inventory on a short-term basis and perhaps even on a daily basis. The pool of inventory may be constantly changing as some inventory is sold and new inventory is manufactured or acquired. In order to obtain each new disbursement of credit with respect to inventory, the grantor usually would present the lender with invoices or a certification indicating the actual status of the inventory serving as security for the new disbursement of credit.

134. In States that do not treat retention-of-title and financial lease rights as security rights, the relative priority of rights is decided by reference to the seller's or lessor's right of ownership. It is implausible that inventory would be acquired under a financial lease, since the principal characteristic of inventory is that it will be sold. In cases involving retention-of-title rights, the position of a lender that finances the acquisition of inventory is especially precarious. Future advances will usually be made on the assumption that all new inventory is acquired under a retention-of-title transaction. It then becomes necessary for the creditor to determine what inventory has actually been fully paid for. This has the effect of complicating a borrower's efforts to obtain future advances secured by the pool of inventory. Nonetheless, the seller will have priority based on its ownership of inventory not yet paid for; only once the inventory is paid for by the buyer may other creditors assert security rights in that inventory.

135. In States that follow the fully integrated approach, the rights of the general inventory financier are more secure. Where the additional assets acquired by the grantor are inventory, the acquisition security right will have priority over a non-acquisition security right in future inventory if the registration of a notice in the general security rights registry is made prior to the delivery of the inventory to the grantor. In addition, in some States that follow the fully integrated approach, pre-existing inventory financiers that have registered their rights must be directly notified that a higher-ranking acquisition security right is being claimed in the new inventory being supplied. The reason for this rule is that it would not be efficient to require the non-acquisition inventory financier to search the general security rights registry every time it advanced credit in reliance upon a pool of ever-changing inventory. In order to avoid placing an undue burden on acquisition secured creditors, however, a single, general notification to pre-existing non-acquisition inventory financiers on record may be effective for all shipments to the same buyer occurring during a significant period of time (for example, five years or the same period that registration lasts to keep a security right effective against third parties). This would mean that, once notification had been given to these pre-existing non-acquisition inventory financiers, it would not be necessary to give a new notification within the given time period for each of the multiple inventory transactions between the acquisition secured creditor and the buyer of the inventory.

136. Under the unitary approach, the additional requirements usually found in States that follow the fully integrated approach are adopted for acquisition security rights in inventory. That is, acquisition secured creditors are able to claim a super-priority over non-acquisition inventory financiers for their acquisition security right only if, prior to the delivery of the inventory to the grantor, they register a notice in the general security rights registry and they also notify in writing earlier-registered non-acquisition financiers (see recommendation 180, alternative A, paragraphs (b) and (c)). Under this approach, acquisition secured creditors do not have a grace period after the buyer obtains possession of the assets within which they may register a notice of their security right.

137. While all States that have adopted the fully integrated approach take the above view, it is possible to imagine a regime that draws no distinction between inventory and assets other than inventory and consumer goods. If such were the case, the principles governing assets other than inventory would also apply to acquisition security rights in inventory. The same rule would apply for all tangible assets, namely that the registration of a notice within a certain period of time after delivery of the tangible assets would be sufficient (see recommendation 180, alternative B).

138. If a State were to adopt the non-unitary approach, it would face a similar choice. On the one hand, equivalent rules relating to the priority of the seller's rights over pre-existing rights in future inventory should be established regardless of the legal form of the transaction. That is, notwithstanding that the retention-of-title seller remains the owner of the assets delivered, the rules governing the sale of inventory should be adjusted so that the seller's title would have priority over pre-existing rights in future inventory only under the same conditions as its rights would have priority were they to arise under an acquisition security right taken by that seller (see recommendation 192, alternative A, paragraphs (b) and (c)). In other words, under this approach, the retention-of-title seller, financial lessor, or seller or lender claiming an acquisition security right would be required, prior to delivery of the inventory to the buyer or lessee, to register a notice of their retained ownership right or their security right, as the case may be, in the general security rights registry and also notify in writing earlier-registered non-acquisition financiers.

139. On the other hand, States might also adopt the position that no distinction should be drawn between equipment and inventory. In that case, a retention-of-title seller, financial lessor, or seller or lender claiming an acquisition security right in inventory would only be required to register a notice of its security right in the general security rights registry either before or within the indicated grace period after the buyer or lessee obtains possession of the assets (see recommendation 192, alternative B).

(f) Multiple acquisition financing transactions

140. In many situations, a seller or other provider of acquisition financing will extend financing to permit the acquisition of several assets. This financing could involve, for example, multiple sales with multiple deliveries of inventory or multiple sales of several pieces of equipment. In these situations, it is necessary to decide, as a matter of policy, whether special priority given to the provider of acquisition financing should extend to all equipment or inventory financed by it, without the need to identify the purchase price due under each particular sale. If so, the legal system in question is said to permit "cross-collateralization".

141. In many States that do not treat retention-of-title transactions and financial leases as security devices, the issue of cross-collateralization usually does not arise. In the normal case of a retention-of-title sale or similar title transaction, the contract of sale or lease applies only to the specific assets sold or leased under that contract. Thus, while the same agreement may cover multiple deliveries, it would not cover multiple sales. The priority claim of the seller or lessor as owner would relate to the specifics of each sale or lease. Some of these States do, however, permit the retention-of-title right to be enlarged by providing, for example, that the parties may agree to an "all monies" or "current account" clause where inventory is being sold. When such clauses are used, the seller retains ownership of the assets sold until all debts owing from the buyer to the seller have been discharged and not just those arising from the particular sales contract in question. In some States, however, retention-of-title sales with "all monies" or "current account" clauses are often characterized by courts as security devices.

142. In States that follow the fully integrated approach, the usual rule is that the special priority of acquisition security rights, at least in inventory, is not impaired by

cross-collateralization. This means that the acquisition secured creditor may claim its special priority in relation to the financed inventory without being obliged to specifically link any outstanding indebtedness to a particular sale or lease transaction or to a particular encumbered asset. In such cases, nonetheless, the special priority does not extend to other inventory or assets the acquisition of which was not financed by that acquisition secured creditor.

143. Under the unitary approach of the *Guide*, the goal is to permit a maximum of flexibility to acquisition secured creditors that provide financing for the acquisition of inventory, and to minimize the transactional paperwork associated with multiple acquisition transactions involving the same acquisition secured creditor. For this reason, a single registration will be sufficient to cover multiple transactions, and a single notice sent to creditors with security rights in future inventory of the type being supplied may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction (see recommendations 68, 178 and 180, alternative A, paragraph (c)). Should a State decide that no distinction should be drawn between inventory and equipment, a single registration would be sufficient and it would not be necessary to send a notification to an earlier-registered general inventory financier (see recommendations 68, 178 and 180, alternative B, paragraph (b)).

144. Under the non-unitary approach of the *Guide*, because a contract of sale or lease normally applies only to the specific assets sold or leased, it would be necessary to modify the rules relating to retention-of-title rights and financial lease rights so as to permit cross-collateralization. Moreover, should a seller or any acquisition secured creditor that is not a seller obtain an acquisition security right in inventory, the seller or other financier should be enabled to exercise a right of cross-collateralization in the same manner as under the unitary approach (see recommendations 192, alternative A, paragraph (c), and 193). Should a State decide that no distinction should be drawn between inventory and equipment, a single registration would be sufficient and it would not be necessary to send a notification to an earlier-registered general inventory financier (see recommendations 192, alternative B, paragraph (b), and 193).

(g) *Priority of rights of acquisition financing providers as against the rights of judgement creditors*

145. In chapter V on the priority of a security right, the *Guide* recommends that the rights of creditors that obtain a judgement and take the enforcement steps necessary to acquire rights in a judgement debtor's assets should generally have priority over existing security rights for advances made after the existing secured creditors are informed of the judgement creditor's rights (see recommendation 84). When the competing right in question is a retention-of-title right, a financial lease right or an acquisition security right, a slightly different set of considerations might be taken into account, depending on the kind of tangible assets at issue. For example, if the tangible assets are consumer goods, the provider of acquisition financing is not required to register a notice of its rights or take possession of the assets in order to make its rights effective against third parties. Hence the ownership rights of a retention-of-title seller or financial lessor will be effective against third parties at the outset of the transaction and no priority competition with a judgement creditor can arise. The judgement creditor simply cannot seize the assets of a person other

than its debtor. Similarly, in the case of consumer goods, conflicts between an acquisition secured creditor and a judgement creditor will be rare since the consumer transaction will rarely involve extensions of credit in the future.

146. If the assets are in the form of inventory, the provider of acquisition financing must have possession of the assets or have registered its rights and (if alternative A of recommendations 180 and 192 is adopted) notified earlier-registered secured creditors of its rights before the buyer obtains possession of the inventory. Hence, the judgement creditor that cannot or has not registered its judgement will not be on notice of the acquisition financier's or acquisition secured creditor's potential rights. Where States permit such a judgement creditor to register a notice of the judgement in the general security rights registry, and treat judgement creditors that have filed such notices as secured creditors, these judgement creditors will receive notice from a subsequent acquisition secured creditor. However, in some cases (such as those involving equipment under alternative A of recommendations 180 and 192, or involving both inventory and equipment under alternative B of recommendations 180 and 192), the provider of acquisition financing is given a grace period within which to register its rights. As with consumer goods, it is seldom the case that a provider of acquisition financing for equipment will be extending credit in the future. This said, when a judgement creditor seeks to enforce its judgement against its debtor's assets, it should not generally be able to defeat the rights of a provider of acquisition financing that adds new value to the judgement debtor's estate.

147. Under the unitary approach of the *Guide*, as long as an acquisition secured creditor makes its rights effective against third parties within the grace period, it will have priority even over judgement creditors that register their judgement during that grace period (see recommendation 183).

148. Under the non-unitary approach, similar protection should be afforded to retention-of-title sellers, financial lessors and acquisition secured creditors that register a notice of their right within the indicated grace period. In the first two cases, this is because the retention-of-title seller and financial lessor simply retain ownership of the asset. However, should the acquisition financier be a seller or a lender that claims an acquisition security right, the special priority of the acquisition security right would follow if registration were made within the grace period (see recommendations 187, subparagraph (a), and 183).

(h) *Priority of rights of acquisition financing providers in attachments to movable property and masses or products*

149. The *Guide* recommends in chapter V on the priority of a security right that a security right in an attachment to movable assets that is made effective against third parties by registration in a specialized registry or by a notation on a title certificate should have priority over a security right in the related assets that is registered subsequently in the general security rights registry or noted on the title certificate (see recommendation 89). This recommendation rests on the fact that security rights that are effective against third parties remain effective even after the assets that they encumber have become attached to other assets. In such cases, if two or more security rights encumber the assets at the time of their attachment, they would maintain their relative priority following attachment. In respect of a mass or product (or, in other words, commingled assets), the *Guide* recommends that such security rights

should continue into the mass or product and that, if there are two or more security rights, they should retain their relative priority in the mass or product (see recommendation 90).

150. In the case of both attachments and commingled assets, however, it is also necessary to determine the relative priority of rights taken in the different tangible assets that are united by attachment or commingled. The *Guide* provides that the regular priority rules apply, so that the time of registration in the general security rights registry would determine priority, unless one of the security rights was an acquisition security right. An acquisition security right taken in a part of commingled assets would have priority over an earlier registered non-acquisition security right (and presumably even an acquisition security right) granted by the same grantor in the whole mass or product (see recommendation 92). The *Guide* does not, however, take a position on whether an acquisition security right in an attachment should have priority over an earlier registered non-acquisition (or even acquisition) security right granted by the same grantor in the tangible assets to which the attachment is affixed.

151. In States that do not consider retention-of-title rights and financial lease rights as security rights, the general priority rules set out in chapter V on the priority of a security right would not directly apply to acquisition financing. That chapter deals with situations where all forms of secured transaction are treated as security rights under the general unitary and functional approach. In the acquisition financing context, however, the relative rights of the parties depend on general rules of property law governing attachments. Normally, if the attached asset can be detached without damaging the assets to which it is attached, the retention-of-title seller would retain its ownership in the attachment. If the attachment could not be so removed, it is necessary to determine whether the attachment or the asset to which it is attached is the more valuable. If the tangible asset of which a seller has retained ownership is more valuable, the retention-of-title seller acquires ownership of the whole, subject only to an obligation to pay the value of the other asset. Conversely, if the tangible asset in which a seller has retained ownership is less valuable, the retention-of-title seller loses its ownership and merely has a claim against the new owner for the value of its former asset.

152. Under the unitary approach of the *Guide*, acquisition secured creditors with rights in attachments or in commingled assets are generally able to claim a special priority over non-acquisition secured creditors. That is, they will have priority over other secured creditors claiming a right in the attachment or in the tangible assets that are being commingled or processed. They will also have priority over non-acquisition secured creditors of the assets to which the attachment is attached, at least in so far as the value of the attachment is concerned, and they will have priority over non-acquisition secured creditors with a security right in the entire mass or product (see recommendations 90-92).

153. If a State were to adopt the non-unitary approach, equivalent rules relating to the priority of the seller's rights over other rights in the attachment or the tangible assets to be commingled or processed should be established regardless of the legal form of the transaction. In other words, notwithstanding that the retention-of-title seller of an attachment might lose its ownership upon attachment, it should be able to claim its priority either in the share of the mass or product that it sold or in the attachment that it sold. The exact mechanism by which the rules of attachments to movable assets would have to be adjusted depends on the detail of the law in each particular State that chooses to adopt the non-unitary approach. The *Guide* recommends a general principle that enables retention-of-title sellers and financial lessors to claim an acquisition security right

in situations where their ownership rights are not effective against third parties (see recommendation 194). This principle could be adapted to apply to situations where, by operation of law, the seller's or lessor's ownership right is extinguished.

(i) *Priority of rights of acquisition financing providers in attachments to immovable property*

154. In chapter V on the priority of a security right, the *Guide* recommends that, after attachment, a security right in attachments to immovable property that is made effective against third parties under immovable property law should have priority over a security right in those attachments made effective against third parties under secured transactions law. Conversely, if the security right in tangible assets is made effective against third parties before attachment and is registered in the immovable property registry, it should have priority over subsequently registered security rights in the immovable property (see recommendations 87 and 88). The logic of these provisions should also apply to retention-of-title rights, financial lease rights and acquisition security rights.

155. The rights of a provider of acquisition financing in a tangible asset that will become an attachment should have priority over existing encumbrances on the immovable property, provided that a notice of the right of the acquisition financing provider is registered in the immovable registry within a reasonable period after attachment. In this case, the person that asserts an existing encumbrance on the immovable property disbursed credit on the basis of the value of the immovable property at the time of the disbursement and presumably had no pre-existing expectation that the attachment would be available to satisfy its claim. However, in cases where the pre-existing encumbrance on the immovable property secures a loan that is intended to finance construction, this same assumption would not hold, and the rationale for preserving the preferred priority of the provider of acquisition financing is less compelling.

156. Under the unitary approach of the *Guide*, a single rule governing these cases is possible since the claim of the acquisition secured creditor will always be a security right. The acquisition secured creditor that takes the steps necessary to make its right effective against third parties by registration in the immovable property registry will have priority, except as against a construction loan that is secured by the immovable property (see recommendation 184). Of course, if the acquisition secured creditor failed to register its right in the general security rights registry within the grace period, the acquisition secured creditor would simply have a non-acquisition security right subject to the recommendations generally applicable to security rights.

157. Should a State adopt the non-unitary approach, however, it will be necessary to adjust the rules relating to attachments to achieve a result that is functionally equivalent regardless of the form of the transaction. That is, it would be necessary to specify that a retention-of-title right and a financial lease right will normally continue to be effective against third parties with existing rights in the immovable property, provided that the seller or lessor registers its rights in the immovable property registry within a short time after the asset becomes an attachment to the immovable property. By contrast, the retention-of-title seller and financial lessor would lose their priority to a construction financier even when the title to the assets being attached does not automatically pass to the owner of the immovable property (as would

be the case for assets sold under retention of title or leased under a financial lease that are fully incorporated into the immovable property) (see recommendation 195). Likewise, a seller or lender with an acquisition security right will have priority should it re-register its rights in the immovable property registry within the same short period. Finally, it would be necessary to provide that, if the seller or lessor failed to register its rights in the general security rights registry within the grace period (see recommendation 195), that seller or lessor would simply have a non-acquisition security right subject to the recommendations generally applicable to security rights (see recommendation 196).

(j) *Acquisition financing priority in proceeds generally*

158. In many cases, the provider of acquisition financing knows that the buyer will resell the assets being acquired. This is obviously the case with inventory, but sometimes a manufacturer or other enterprise will sell existing equipment in order to acquire upgraded equipment. As discussed in chapter II on the creation of a security right, an ordinary security right in tangible assets will normally extend to the proceeds of its disposition (see recommendation 19). In the case of acquisition financing, this extension of a security right into proceeds raises three distinct policy questions. The first policy question relates to whether a similar extension to proceeds should be possible where the acquisition financing is by way of retention-of-title right or financial lease right. The second policy question is whether the special acquisition financing priority should also apply to proceeds. The third policy question is whether the rules for making such a claim should be the same regardless of whether equipment or inventory is being purchased.

159. While it is extremely rare, some States that do not treat retention-of-title rights and financial lease rights as security rights permit the seller or lessor to extend its ownership claim to proceeds generated by the sale of the assets when these proceeds are tangible assets of the same type as those sold, such as a vehicle received by the seller as a trade-in upon the purchase of a new vehicle. When the proceeds of disposition of an asset are in the form of receivables, the ownership right is invariably extinguished. Nonetheless, in some States, the retention-of-title right and financial lease right in original encumbered assets are converted into a security right in the intangible proceeds, although, once again, this is not the common practice.

160. The *Guide* recommends that a retention-of-title right or a financial lease right should permit the seller or lessor to claim a right in proceeds and that, consistent with the position found in almost all of those few States that already extend the retention-of-title right to proceeds, this right should always be a security right and not a continuation of the ownership right (see recommendation 197). The second and third policy questions relating to proceeds of assets sold under retention of title or subject to a financial lease are discussed in the next two subsections.

(k) *Acquisition financing priority in proceeds of tangible assets other than inventory or consumer goods*

161. In States that do not treat retention-of-title rights and financial lease rights as security rights, the issue of a seller or lessor claiming special rights in proceeds generated by

the sale of equipment, while theoretically possible, usually does not arise. This is because the law of sale or lease usually limits the seller's retained ownership right or the lessor's ownership only to the assets sold or leased. In cases of unauthorized disposition, the seller or lessor may be able to recover the asset in kind from the person to which it has been transferred. However, sometimes the assets cannot be found, even though assets or money received in connection with their disposition can be identified. In addition, sometimes the seller or lessor permits the sale of the assets on the condition that the seller's or lessor's title is extended to the proceeds of the sale. In these two situations, a few States permit the seller or lessor to claim ownership based on the principle of subrogation of property rights to the proceeds of the assets sold under a retention-of-title or financial lease transaction, as long as these proceeds are tangible assets of the same type as the original encumbered assets. Where the contract is a sale, it is common to speak of the seller's rights as an "extended retention of title". In the majority of cases where such an extension is possible, however, the retention-of-title right or financial lease right is not maintained as an ownership right, but is converted into a security right in the proceeds.

162. In some States that follow the fully integrated approach, the special priority of an acquisition security right extends only to the assets the acquisition of which is financed, and not to the proceeds of their disposition. That is, while the acquisition financier retains a security right in proceeds by virtue of the general principle, it cannot claim the special priority of an acquisition financing right. In other States the special priority may extend to identifiable proceeds as well, at least in the case of transactions relating to equipment. Since the grantor does not usually acquire equipment with a view to its immediate resale, there is little concern about prejudicing other secured creditors if the special priority of an acquisition security right in equipment is extended to the proceeds of its disposition. If the equipment becomes obsolete or is no longer needed by the grantor, and is later sold or otherwise disposed of by the grantor, the secured creditor will often be approached by the grantor for a release of the security right to enable the grantor to dispose of the equipment free of the security right. Absent that release, the disposition would be subject to the security right and it would be unlikely that a buyer or other transferee would pay full value to acquire the equipment. In exchange for the release, the secured creditor will typically control the payment of the proceeds, for example, by requiring that the proceeds of the disposition be paid directly to the secured creditor for application to the secured obligation. Under these circumstances, it is unlikely that another creditor would rely upon a security right taken directly in an asset of the grantor that represents proceeds of the disposition of the equipment initially subject to an acquisition security right.

163. Under the unitary approach of the *Guide*, the assumption is that, unlike inventory, equipment is not normally subject to ongoing turnover. The acquisition secured creditor's control over the disposition of the asset supports the conclusion that the special priority afforded to acquisition secured creditors should be extended to proceeds of disposition and products of the assets covered by the acquisition security right (see recommendation 185, alternative A, paragraph (a)). If a State decides that no distinction should be drawn between inventory and equipment, it will be necessary to determine whether the priority of the acquisition security right should extend to the proceeds. Since the bulk of sales giving rise to proceeds will be sales of inventory, the *Guide* recommends that, in the case of equipment, the security right in the proceeds should have the priority of a non-acquisition security right (see paras. 169-170 below and recommendation 185, alternative B).

164. If a State adopts the non-unitary approach, the rules relating to the maintenance of a special priority in proceeds of equipment should produce the same consequences as against other claimants regardless of the legal form of the acquisition financing transaction. That is, the special priority of the retention of title seller or financial lessor of equipment should be claimable in the proceeds of disposition, either by continuing the seller's or lessor's title in the proceeds or by giving the seller or lessor a replacement security right with the same priority claim as a seller or lender that took an acquisition security right. Since it is rare that States permit sellers and lessors to assert their rights of ownership in intangible proceeds, in order to maintain consistency with respect to all forms of proceeds, the *Guide* recommends that the seller's and lessor's acquisition security rights in original encumbered assets should be transformed into a security right in the proceeds (see recommendation 197).

165. It would also be necessary to provide for the third-party effectiveness of this security right in proceeds through rules relating to a registration of a notice or another method for achieving third-party effectiveness (see recommendation 198). Finally, it would be necessary to provide that, in such cases, this right has the same priority against other claimants as if it were an acquisition security right taken by a seller or a lender. If a State decides that a distinction should be drawn between inventory and equipment, the retention-of-title seller's or financial lessor's control over the disposition of the asset argues for maintaining the special priority afforded to acquisition secured creditors in the case of equipment (see recommendation 199, alternative A, paragraph (a)). Should a State decide that no distinction should be drawn between inventory and equipment, it will be necessary to determine whether the priority of the retention-of-title right or financial lease right should be claimable in the proceeds. Since the bulk of sales giving rise to proceeds will be sales of inventory, the *Guide* recommends that the security right in the proceeds should have the priority of a non-acquisition security right (see paras. 171-172 below and recommendation 199, alternative B, first sentence). For the same reason, a similar principle should apply to the proceeds of an acquisition security right in all types of encumbered assets (see recommendation 199, alternative B, second sentence).

(l) *Acquisition financing priority in proceeds of inventory*

166. The situation in relation to proceeds of inventory is different from that relating to proceeds of equipment for three reasons. First, inventory is expected to be sold in the ordinary course of business of an enterprise. Second, the proceeds of the sale of inventory will predominantly consist of receivables rather than some combination of a trade-in and receivables. To take an example, it would not normally be the case that a seller of furniture would take back the purchaser's used furniture in partial payment of the purchase price. Third, it will often be the case that a pre-existing secured creditor, in extending working-capital credit to the grantor, will be disbursing credit to the grantor on a periodic or even daily basis in reliance upon its superior security right in an ever-changing pool of existing and future receivables as original encumbered assets. It may not be possible or practical for the grantor to segregate the receivables that are the proceeds of the inventory subject to a retention-of-title right, a financial lease right or an acquisition security right from other receivables over which a pre-existing creditor has taken a security right. Even if such segregation were possible or practical for the grantor, the grantor would have to do it in a way that was transparent to both financiers and that minimized monitoring by both financiers.

167. Without such a prompt segregation that is transparent to both financiers and that minimizes monitoring, there is a significant risk that the pre-existing secured creditor extending credit against receivables would mistakenly assume that it had a higher-ranking security right in all of the grantor's receivables. There is likewise a risk of a dispute between the pre-existing secured creditor and the retention-of-title seller, financial lessor or acquisition secured creditor as to which financier has priority in which proceeds. All of those risks and any concomitant monitoring costs may result in the withholding of credit or charging for the credit at a higher cost. If the priority of the right of the provider of acquisition financing in the inventory does not extend to the proceeds, that provider of acquisition financing may itself withhold credit or offer credit only at a higher cost.

168. However, that risk may be mitigated in a significant respect. For example, if the priority of the retention-of-title right, financial lease right or acquisition security right in the inventory does not extend to proceeds in the form of receivables, a pre-existing receivables financier with a prior security right in future receivables of the grantor could extend credit based on such receivables knowing that it has a higher-ranking security right in such receivables than the acquisition financier of inventory. This also benefits the acquisition financier, because disbursements made by the receivables financier can enable the grantor to pay for the inventory acquired by the grantor. The amount of the advance by the pre-existing secured creditor should be sufficient to enable the grantor to pay the purchase price to the seller of the inventory on a timely basis. This is because advance rates against receivables generally are much higher than those against inventory and because the amount of the receivables reflects a resale price for the purchase of the inventory well in excess of the cost of the inventory to the seller. Thus, resolving this priority issue in this manner promotes both inventory acquisition financing and receivables financing.

169. Under the unitary approach, the complexity of determining what receivables arise from the disposition of assets in which an acquisition security right exists and the widespread use of receivables as assets subject to a separate security right are cogent reasons why the special priority afforded to acquisition security rights in inventory should be limited to proceeds of disposition other than receivables and other payment rights, such as negotiable instruments, rights to payment of funds credited to a bank account and rights to receive proceeds under an independent undertaking. As a result, in cases where States distinguish between proceeds of equipment and proceeds of inventory, they typically also distinguish between kinds of proceeds. In these States, should the proceeds of inventory take the form of receivables and other payment rights, the security right has the priority of a non-acquisition security right. Should the proceeds take any other form, the security right will continue to have the priority of an acquisition security right, provided that the acquisition secured creditor gave notice of its right to secured creditors that registered a notice of a security right in assets of the same kind as the proceeds before the proceeds arose (see recommendation 185, alternative A, paragraph (b)).

170. While all States that have adopted the fully integrated approach take the above-mentioned view, it is possible to imagine that no distinction should be drawn between proceeds of inventory and proceeds of assets other than inventory or consumer goods. If such were the case, States might provide that the principles governing assets other than inventory and consumer goods should also apply to acquisition security rights in inventory. However, because the right in proceeds would also extend to receivables and other payment rights in relation to inventory, where competition with receivables financiers

would be common, the *Guide* recommends that the security right in all types of proceeds should not have the special priority of an acquisition security right but rather should only have priority according to the general rules applicable to non-acquisition security rights (see recommendation 185, alternative B).

171. If a State were to adopt the non-unitary approach as recommended in the *Guide*, it would face the same choice. Where a distinction is drawn between equipment and inventory, the special priority given to retention-of-title sellers, financial lessors and acquisition secured creditors that finance inventory should not be extended to proceeds of disposition in the form of receivables and other payment rights, regardless of the legal form of the acquisition financing transaction. However, States might choose to maintain the special priority of the retention-of-title seller, financial lessor or acquisition secured creditor over proceeds of inventory that take the form of tangible assets, provided that the retention-of-title seller, financial lessor or acquisition secured creditor gives notice of its right to secured creditors that registered a notice of a security right in assets of the same kind as the proceeds before the proceeds arose (see recommendation 199, alternative A, paragraph (b)).

172. Alternatively, it is possible to imagine that no distinction should be drawn between proceeds of inventory and proceeds of assets other than inventory or consumer goods. In this hypothesis, States might provide that the principles governing assets other than inventory should also apply to acquisition security rights in inventory. However, because the right in proceeds would also extend to receivables and other payment rights in relation to inventory, where competition with receivables financiers would be common, the *Guide* recommends that the security right in all types of proceeds should not have the special priority of an acquisition security right, but rather should only have priority according to the general rules applicable to non-acquisition security rights (see recommendation 199, alternative B).

(m) Priority as between rights of competing providers of acquisition financing

173. In the various priority conflicts described so far in this section, the competing claimants are asserting different rights in tangible assets. That is, the conflicts are between the rights of a retention-of-title seller, financial lessor or acquisition secured creditor, on the one hand, and mainly a non-acquisition secured creditor, on the other hand. In a few cases, however, the competition could be between two claimants, each of which is asserting rights arising from an acquisition financing transaction. Depending on the applicable law of a given State, the usual circumstance in which this may occur is when a lender provides credit to a buyer so as to enable the buyer to make a down-payment for an asset and the seller also offers credit terms to the buyer for the remainder of the purchase price of the asset.

174. In States that do not treat retention-of-title rights and financial lease rights as security rights, the relative priority of claims is decided by reference to the seller's or lessor's right of ownership. Unless that system permits other creditors to obtain a security right in the expectancy right of the buyer, competition between owners and secured creditors would not arise. Further, even if it were possible for a creditor to obtain a security right in a buyer's or lessee's expectancy right, that expectancy right will only mature once the seller or lessor is fully paid. In other words, in most States with such systems, there can

never be direct competition between a lender claiming rights under an acquisition financing transaction and a seller or lessor. The only way that a lender could acquire an acquisition financing right would be to obtain an assignment of the secured obligation from the retention-of-title seller or the financial lessor.

175. Furthermore, in States that do not treat retention-of-title rights and financial lease rights as security rights, it is often possible for a seller (although not a lessor) to transfer title to the asset being sold to the buyer and take back a security right. Sometimes these seller's rights arise by operation of law, but often they arise from an agreement between the seller and the buyer. In such cases, the buyer may well grant competing security rights in the asset being acquired. These rights will sometimes be security rights granted after the asset has been purchased. However, less commonly, they might also arise beforehand, by virtue of a general security right covering present and future assets. Nonetheless, even when the lender advances credit to enable a buyer to acquire the assets, the security right it obtains in those assets is invariably considered to be a non-acquisition security right. That is, in most States that do not treat retention-of-title rights or financial lease rights as security rights, it is not possible for lenders to accede directly to the special priority position that is given to a seller that transfers ownership to a buyer and takes back an acquisition security right. Once again, in most such States the only way that a lender could acquire the special priority position afforded to an acquisition security right would be to obtain an assignment of the secured obligation from the seller that has obtained such a security right.

176. In States that follow the fully integrated approach, the priority rights of a seller and a lessor are protected because the rights they would otherwise claim as owners are characterized as acquisition security rights and are given the same preferred priority position through the concept of the "purchase-money security interest" special priority. Such a preferred priority position is also afforded to sellers that simply obtain a security right in the assets being supplied and to lenders that advance money to borrowers so as to enable them to purchase those assets. In other words, under the fully integrated approach, it is possible to have a genuine conflict between more than one acquisition security right. The normal priority rule in such States is that, as between competing security rights of the same type, the first to register or, if another method for achieving third-party effectiveness is used, the first to achieve third-party effectiveness would prevail. Thus, for example, as between two lenders that may both claim an acquisition security right, the first to register will have priority. It may be, however, that a seller that claims an acquisition security right registers its notice after a lender that provided acquisition financing has done so. In this one case, these systems override the usual priority rule so as to protect the seller of the asset being sold. The seller that makes its acquisition security right effective against third parties will have priority even over lenders with pre-existing acquisition security rights.

177. Under the unitary approach of the *Guide*, in any competition between a seller that is claiming an acquisition security right and a lender that is also claiming an acquisition security right, the seller's acquisition security right will have priority regardless of the respective dates that these acquisition security rights were made effective against third parties (see recommendation 182). In addition, in a competition between two acquisition security rights taken by lenders, the normal priority rules apply. That is, the time at which the respective rights of the two lenders were registered or became

effective against third parties, whichever occurred first, will determine their relative priority (see recommendation 76, subparagraph (c)).

178. In States that choose to adopt the non-unitary approach, an initial policy decision is whether to permit financiers other than sellers or lessors to take security rights in assets being acquired by their borrower that can achieve the preferred priority status of an acquisition security right. If not, there will never be competition between two or more acquisition financiers. The *Guide* recommends that, even when assets are sold under a retention-of-title arrangement or are subject to a financial lease, the buyer should be able to grant security over the asset being sold or leased (see recommendation 190, first sentence). Moreover, it also recommends that lenders that provide acquisition financing to buyers should be permitted to claim an acquisition security right (see recommendations 187 and 188). As a result, States that adopt the non-unitary approach will also face possible competition between providers of acquisition financing. Should the competition be between a retention-of-title seller or a financial lessor and a lender, the seller or lessor will always have priority as a consequence of its right of ownership. The rights of the lender that provides acquisition financing will necessarily be subordinated to the ownership rights of the seller or lessor. For this reason, the maximum amount that the lender could claim under its acquisition security right would be the asset's value in excess of the amount owing to the seller or the financial lessor (see recommendation 190, second sentence). If the competition is between a seller or lessor that claims an acquisition security right and a lender claiming such a right, in order to achieve the same result, States will have to adopt a rule that provides for the priority of the seller's or lessor's acquisition security right, whatever their respective dates of effectiveness against third parties. Moreover, States will also be required to specify that, as between acquisition security rights taken by financiers other than sellers or lessors, the priority of these rights will be determined by the time they were registered or became effective against third parties, whichever occurred first, regardless of the form of the transaction. This is the position recommended in the *Guide*, namely that the regime of acquisition security rights applicable in the non-unitary context should be identical to the regime adopted in the context of the unitary approach (see recommendation 187, paragraph (a), incorporating the principle reflected in recommendation 182).

(n) *Effect of the failure of a provider of acquisition financing to make its acquisition rights effective against third parties*

179. Normally, a retention-of-title seller, a financial lessor or a seller or lender that obtains a security right in assets being acquired by a buyer will ensure that it has taken all the steps necessary to make its rights effective against third parties. In the case of a retention-of-title right or a financial lease right, this means following one of the methods for achieving third-party effectiveness and, in cases where this is accomplished through registration in the general security rights registry, doing so within the indicated time (see recommendation 192). In the case of an acquisition security right, whether under the unitary or non-unitary approach, the secured creditor must take the steps necessary to achieve third-party effectiveness, and if that step is registration in the general security rights registry, it must do so within the indicated time (see recommendations 180 and 192).

180. The failure to achieve third-party effectiveness within the applicable time period has significant consequences for all providers of acquisition financing. Should an acquisition

secured creditor fail to register in a timely fashion (see paras. 108-111 above), this does not mean that it loses its security right. The security right nevertheless remains effective between the parties. Provided that the secured creditor takes the steps necessary to achieve third-party effectiveness even after the expiry of the grace period, the secured creditor will be an ordinary, non-acquisition secured creditor, subject to the general priority rules applicable to security rights. It will not, that is, be able to claim an acquisition security right or assert the special priority associated with that right.

181. The situation is slightly different where a retention-of-title seller or a financial lessor fails to make its rights effective against third parties in a timely way. In these cases, the seller or lessor loses the benefit of its ownership and, in so far as the rights of third parties are concerned, title to the asset being sold or leased is transferred to the buyer or lessee. The complete loss of rights is a severe consequence to attach to the failure to take the steps necessary to achieve third-party effectiveness in a timely manner. In order to palliate these consequences and to parallel the result reached in respect of acquisition security rights, it is necessary to convert the right of the seller or lessor that does not become effective against third parties in a timely way into an ordinary security right, subject to the general priority rules applicable to security rights (see recommendation 194).

182. A similar conclusion should be reached in other cases where a retention-of-title seller or a financial lessor is deprived of its rights of ownership. For example, if a seller or lessor fails to register a notice of its retention-of-title right or financial lease right in a tangible asset that becomes an attachment to immovable property after the attachment and within the time period provided in recommendation 195, the seller or lessor loses its ownership right in the attachment. However, once third-party effectiveness is achieved, the seller or lessor may claim an ordinary security right (see recommendation 196).

9. *Pre-default rights and obligations of the parties*

183. As already noted (see chapter VI on the rights and obligations of the parties, paras. 8-13), in most States there are very few mandatory rules setting out pre-default rights and obligations of the parties. The vast majority of applicable rules and principles are non-mandatory and may be freely derogated from by the parties. In addition, for the most part the pre-default rights and obligations of the parties will depend on how any particular State conceives the legal nature of the transaction by which acquisition financing is provided.

184. In States that do not treat retention-of-title rights and financial lease rights as security rights, the regime governing pre-default rights and obligations applicable to non-acquisition security rights cannot be simply transposed to the regime governing acquisition financing. The rules applicable to acquisition security rights, whether taken by a seller, by a lessor or by a lender, will mirror those applicable to non-acquisition security rights. However, where a retention-of-title right, financial lease right or similar right is involved, it will be necessary to adjust the manner in which these rules are expressed.

185. As the objective is to achieve functional equivalence among all acquisition financing transactions, this will often require reversing the default presumptions about the prerogatives of ownership. That is, normally it is the owner (the retention-of-title seller or the

financial lessor) that has the right to use an asset and to collect the civil and natural fruits it produces. Normally it is the owner that bears the risk of loss and, therefore, has the primary obligation to care for the asset, maintain it, keep it in good repair and insure it; and normally, it is the owner that has the right to encumber the asset further and to dispose of it. In order to achieve the desired functionally equivalent results, therefore, these States will have to provide a mix of mandatory and non-mandatory rules vesting each of these prerogatives and obligations in the buyer and not in the seller or lessor.

186. States that adopt the unitary approach need not attend directly to this issue, since an acquisition security right is simply a category of security right. As such, it would only be necessary to apply the regular rules about pre-default rights and obligations to all acquisition financing transactions, regardless of the form of the transaction in question. That is, there is no reason to assume that obligations relating to the use of the encumbered assets, the obligation to preserve their value, the collection of natural and civil fruits or revenues, the right to encumber the assets or the right to dispose of them should be any different simply because the security right at issue is an acquisition security right. If acquisition secured creditors and grantors wish to provide for a different allocation of rights and obligations, they should be permitted to do so within exactly the same framework as applicable to non-acquisition security rights (see recommendations 110-113).

187. Should a State adopt the non-unitary approach, however, the specific pre-default rights and obligations of the parties will have to be spelled out in greater detail in order to achieve functional equivalence. In relation to retention-of-title sellers and financial lessors, these rules will often have to be enacted as exceptions to the regular regime of ownership rights. As already noted (see chapter VI on the rights and obligations of the parties, paras. 14-15), most of the pre-default rules will not be mandatory. However, as the non-mandatory default regime should establish a set of terms about pre-default rights and obligations that the legislature believes the parties would choose to most efficiently achieve the purpose of a security device, States that do adopt the non-unitary approach should ensure the enactment of non-mandatory rules that mirror those it enacts to govern acquisition security rights taken by sellers or lenders. So doing would have the additional advantage of clearly specifying the right of the buyer to grant security over its expectancy right, and confirming the buyer's right to use, transform or process the assets in a reasonable manner consistent with its nature and purpose (see recommendations 110-113).

10. Enforcement

188. The discussion in chapter VIII on the enforcement of a security right illustrates that in most legal systems the rules relating to enforcement of post-default rights flow directly from the manner in which that legal system characterizes the substantive right in question. For example, many systems consider certain rights to be "property rights" and provide for special remedies to ensure their effective enforcement. Other rights are characterized as "personal rights" and are usually enforced by bringing an ordinary legal action against a person. In such systems, both the right of ownership and security rights in tangible assets are seen as a category of "property right" enforceable through an *in rem* action (an "action against the asset"). Although the specifics of enforcement of property rights through *in rem* actions can vary greatly depending on the particular property right enforced and the specific configuration of a State's procedural laws, for the most part these rules governing

enforcement of post-default rights are mandatory. As such, they cannot be derogated from by the parties to an acquisition financing transaction.

189. In States that do not treat retention-of-title rights and financial lease rights as security rights, the procedure for enforcement of the seller's or the lessor's rights normally will be the same procedure available to any person that claims ownership in tangible assets. Thus, for example, upon default by the buyer, the retention-of-title seller may terminate the sale agreement and demand return of the assets that it owns. In that event and subject to any term of the agreement to the contrary, the seller is normally also required to refund at least a part of the price paid by the buyer. The amount of the payment due by the seller is often calculated by requiring reimbursement of all money received from the buyer, minus the rental value of the asset while in the possession of the buyer and the amount by which the value of the asset has decreased as a result of its use by the buyer.

190. In these States, a seller that terminates the sale is usually not obliged to account to the buyer for any of the profits made on any subsequent resale of the asset but, at the same time, unless otherwise provided by contract, the seller has no claim against the buyer for any deficiency beyond any direct damages resulting from the buyer's breach of the original sales contract. In some legal systems, courts have also ruled in certain instances that there is an implied term in retention-of-title arrangements that the seller cannot repossess more of the assets sold than is necessary to repay the outstanding balance of the purchase price. Finally, in most of these States, neither the defaulting buyer nor any third party, such as a judgement creditor or a creditor that has taken security on the expectancy right of the buyer in the asset being reclaimed by the seller, may require the seller to abandon its right to recover the assets. As the seller is and always has been the owner of the assets being reclaimed, it cannot be compelled to sell those assets as if it were simply an acquisition secured creditor enforcing an acquisition security right. The only recourses of judgement creditors, secured creditors and other acquisition secured creditors are: (a) if the seller or lessor agrees, to purchase the rights of the seller or lessor, thereby becoming subrogated to the seller's or lessor's rights; or (b) to pay whatever is outstanding under the contract and then exercise their rights in the assets that, as a result of such payment, are thereafter owned by the buyer or lessee.

191. The position of a seller that reclaims ownership and possession of assets under a proviso that, having transferred ownership to the buyer, it may retroactively set aside the sale should the buyer not pay the purchase price as agreed (a "resolutive condition") is similar to that of the retention-of-title seller. Upon default, the sale is terminated, and the seller reacquires ownership. It may then reclaim possession of the assets as the owner subject to reimbursing the buyer for whatever has been paid (discounted as appropriate in the manner already indicated). In other words, once the resolutive condition takes effect, the rights and obligations of the seller that regains ownership are identical to those of the retention-of-title seller.

192. The situation of the financial lessor is normally slightly different. A lease is a contract of continuing performance. The lessee has continuing possession and use of the asset, while the lessor has a continuing right to payment of the rent. As a consequence, normally the lease contract will be terminated for the future only. This means that the lessee will lose any right it may have under the lease agreement to purchase the leased assets at the end of the lease or to automatically acquire ownership of such assets. It also means

that the lessor will keep the full rental payments received and that the lessee will be obliged to return the assets to the lessor. Subject to any contrary provision in the lease agreement, however, the financial lessor will not be able to claim damages for the normal depreciation of the assets. Damages will be claimable only for waste or extraordinary depreciation. Moreover, unless the lease agreement provides otherwise, financial lessors will not usually be able to claim any shortfall between the amounts they receive as rent and the normal depreciation of the leased assets.

193. Under the unitary approach, the acquisition secured creditor would have the same rights to repossess the assets as would any other secured creditor. Whether the acquisition secured creditor is a seller, lessor or lender, it will be able, as outlined in chapter VIII on the enforcement of a security right (see paras. 57-70), either to sell the assets or, if the grantor or other secured creditor do not object, to take the assets in satisfaction of the secured obligation. In the former case, the enforcing creditor will be able to sell under judicial process or privately. Having sold the assets, the secured creditor then has to return to the grantor any surplus above its outstanding claim generated by the resale of the assets, but concomitantly it has an unsecured claim for any deficiency after the sale (see recommendations 152-155 and 178).

194. If a State adopts the non-unitary approach, several adjustments to existing rules relating to the enforcement of the ownership right of a retention-of-title seller or a financial lessor would have to be made in order to achieve equality of treatment among all providers of acquisition financing. These adjustments could include, for example, giving the buyer or lessee, and any secured creditor with a right in the buyer's or lessee's expectancy right, the right to compel a seller or lessor to sell the assets in which it has an ostensible right of ownership, rather than simply assert that ownership right to regain possession of and ultimately to retain or dispose of the assets. Sellers and lenders with acquisition security rights may propose to take the assets in satisfaction of the buyer's outstanding obligation, but the buyer or another interested party may compel the acquisition secured creditor to sell the assets instead. Achieving full functional equivalence would mean that buyers and other interested parties would be enabled to compel the retention-of-title seller to abandon the assertion of its right of ownership and to sell the assets as if it were an acquisition secured creditor. It would also require adjusting the seller's or lessor's rights so that they would be required to account for a surplus upon any sale in the context of enforcement, while at the same time permitting them to recover any deficiency as simple contractual claimants without having to bring a separate action for damages.

195. Deficiencies are much more common than surpluses. Still, requiring all providers of acquisition financing (including retention-of-title sellers and financial lessors) to account to the buyer and other creditors with security rights in the expectation right of the buyer for any surplus upon enforcement will encourage those other creditors to monitor the enforcement process closely and thereby enhance the chances that the highest possible value will be achieved. Likewise, providing the provider of acquisition financing with a deficiency claim allows the creditor to enforce its full claim, which enhances the likelihood of complete repayment. A rule that would deny, absent a contractual term for damages, a deficiency claim to certain providers of acquisition financing (notably retention-of-title sellers or financial lessors), when such a deficiency claim would be enforceable by a seller or lender that exercised an acquisition security right, would be unfair and inefficient. The rights of a seller, especially, should not be significantly different (either to the

seller's advantage or to its disadvantage), depending only on whether it chose to retain title or to take an acquisition security right.

196. As a matter of strict legal logic, it is possible to achieve functionally equivalent enforcement results regardless of whether a unitary or a non-unitary approach is adopted. The need for these several adjustments to existing retention-of-title and financial lease regimes in order to achieve the full benefit of treating all sources of acquisition financing equally suggests that it may be preferable for States that have not already achieved this coordinated result through legislative, judicial or contractual adjustments to their rules governing retention-of-title rights and financial lease rights to do so by adopting the unitary approach. Nonetheless, the non-unitary approach will, if implemented so as to achieve functionally equivalent enforcement results as recommended in the *Guide* (see recommendation 200), produce an efficient enforcement regime for acquisition financing transactions.

11. Conflict of laws

197. Many legal systems differentiate between rights of ownership arising under a contract of sale or lease and security rights in presenting rules relating to the applicable law. That is, conflict-of-laws rules relating to obligations (for example, not only sales and leases, but also licences and receivables) may differ from those applicable to agreements creating a security right in tangible assets. The discussion of conflict-of-laws issues in relation to security rights is included in chapter X on conflict of laws. The present discussion only addresses whether retention-of-title rights, financial lease rights and acquisition security rights should be the subject of different recommendations.

198. Notwithstanding the conceptual differences between rights that flow from ownership and security rights, when a retention-of-title right is being used to secure the performance of a payment obligation and possession has been transferred to the buyer, the appearance of the transaction is no different from that where a non-possessory security right is created. Moreover, the asset in question is equally mobile, and is consequently equally likely to cross international borders. As the *Guide* recommends that lenders should be able to acquire not only security rights but also acquisition security rights in the expectancy of a buyer, it is possible that once an asset crosses a border and unless the same conflict-of-laws rules are applicable to all such rights, different laws will govern the retention-of-title right and the acquisition security right. The *Guide*'s objectives of efficiency and transparency of transactions would suggest that this type of conflict should be avoided if at all possible, and that the same conflict of laws rules should govern both types of transaction.

199. Under the unitary approach, whether an acquisition financing transaction involves a retention-of-title right, a financial lease right or an acquisition security right is immaterial for conflict-of-laws purposes. All will be considered as security rights and dealt with accordingly (see recommendation 178).

200. Should a State decide to retain the non-unitary approach, however, it will face the question of whether the conflict-of-laws rules applicable to the creation, third-party effectiveness, priority and enforcement of retention-of-title rights, financial lease rights and similar arrangements should be the same as those that apply to acquisition security rights or,

more generally, to ordinary security rights that are taken in the same type of asset. The goal of achieving functionally equivalent outcomes is a powerful argument for States to characterize the ownership rights of retention-of-title sellers and financial lessors as equivalent to acquisition security rights for conflict-of-laws purposes (see recommendation 201).

12. Transition

201. The rules recommended in the *Guide* relating to the treatment of transactions that in many States were not considered to be security devices represent a significant change for most legal systems. In particular, the characterization of retention-of-title rights and financial lease rights (including rights under hire-purchase agreements) as acquisition security rights will bring about an important modification to the scope of secured transactions law in legal systems that have not already adopted the unitary and functional approach to secured transactions generally. Chapter XI on transition discusses principles that should govern the transition to the new regime for ordinary security rights as recommended in the *Guide*. These same principles should regulate the transition in relation to acquisition financing transactions.

202. If a State were to adopt the unitary approach, a smooth transition will depend on attending to the detail of the previous regime governing retention-of-title rights and financial lease rights. For example, if it was already obligatory for retention-of-title sellers and financial lessors to register their rights, then it would only be necessary to provide for a certain delay within which the registration would have to be renewed in the new general security rights registry. Alternatively, the law could provide that the existing registration would remain effective for a sufficiently long time period (for example, three to five years) to cover the lifespan of most retention-of-title or financial lease arrangements (see recommendation 231, paragraph (b)).

203. In States where no registration of these rights is currently necessary, a smooth transition could be achieved if, consistent with the transition rules applicable to non-acquisition financing transactions, the effectiveness of the rights of retention-of-title sellers and financial lessors against third parties and their priority position were capable of being preserved by registering an appropriate notice in the general security rights registry. Alternatively, the law could provide that the registration requirement would take effect at a date sufficiently far in the future after the new law comes into force (for example, three to five years) so that it would cover the lifespan of most retention-of-title and financial lease arrangements existing at the time the new law came into force (see recommendation 231, paragraph (b)). In order to ensure coherence of the transition, and consistent with the approach taken in chapter XI on transition, whatever the length of the transition period that is adopted, it should be the same for rights that had to be registered under prior law, for rights that were exempt from registration under prior law and for non-acquisition security rights.

204. If a State decides to adopt the non-unitary approach, in order to establish an efficient secured transactions law, it will be necessary to modify a number of rules relating to retention-of-title rights and financial lease rights. As the *Guide* recommends that a notice should be registered in the general security rights registry, the same transition rules for registration applicable to security rights under the unitary approach could be adopted for

security rights, retention-of-title rights and financial lease rights under the non-unitary approach. As for existing acquisition security rights, the transition should be governed by the same principles as apply to the transition under the unitary approach.

205. In order to put these principles into operation in a manner that produces outcomes that are functionally equivalent to those achieved under the unitary approach, however, various adjustments to the substance of the law relating to retention-of-title rights and financial lease rights would be required. In particular, it would be necessary to determine when the rules relating to the following issues would come into effect: (a) the priority of acquisition financing rights in proceeds; (b) the rights of third parties to acquire security rights in assets subject to a retention-of-title right or a financial lease right; and (c) the procedures for enforcing these types of acquisition financing device, including the rights of third parties in such enforcement procedures. While the scale and scope of the needed transition under the non-unitary approach initially might not appear to be as great, the issues that arise in practice will be identical to those arising under the unitary approach and the general principles governing adoption of a unitary regime should also apply to the transition to a reformed non-unitary regime.

13. Insolvency

206. One of the central themes of the *Guide* is that a security right has little or no value to a secured creditor unless it is given appropriate recognition in insolvency proceedings of the grantor. Thus, an effective secured transactions regime must go hand in hand with an effective insolvency law. Both are essential to promoting secured credit. For this reason, this *Guide* goes hand in hand with its companion guide, the UNCITRAL Insolvency Guide.

207. The general interaction of insolvency law and secured transactions law is addressed in chapter XII of the present *Guide*. The *Guide*'s recommendations on this topic are in two parts: Part A, which reproduces those recommendations of the UNCITRAL Insolvency Guide that have a direct bearing on secured transactions, and Part B, which is comprised of additional recommendations that are intended to supplement those of the UNCITRAL Insolvency Guide. The UNCITRAL Insolvency Guide generally defers to non-insolvency law (for example, a State's secured transactions law) with respect to how a particular acquisition financing transaction is characterized and the legal implications of that characterization. In other words, whether a State characterizes any particular type of acquisition financing transaction as an acquisition security right or as an ownership right, such as a retention-of-title right, is a matter of secured transactions law, and not a matter of insolvency law.⁶

208. The principle that insolvency law generally defers to non-insolvency law on matters of characterization means that, in States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases will be treated in the grantor's insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. Accordingly, the provisions of the UNCITRAL

⁶See footnote 6 to recommendation 35 of the UNCITRAL Insolvency Guide.

Insolvency Guide applicable to security rights would apply to acquisition security rights. Thus, if a State were to adopt the unitary approach, the insolvency law should treat assets subject to any type of acquisition security right in the same way as assets subject to security rights generally (recommendation 186).

209. A slightly more complicated analysis is required in States that do not treat retention-of-title transactions and financial leases as security devices. Some of these States maintain separately denominated retention-of-title transactions and financial leases but subject them and similar arrangements to the same rules that apply to non-acquisition security rights, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. That is, in these States the ownership of retention-of-title sellers and financial lessors is converted by secured transactions law into a security right when the grantor becomes insolvent. Consequently, the same outcome in insolvency is reached as is achieved in States with fully integrated regimes. Accordingly, the provisions of the UNCITRAL Insolvency Guide applicable to security rights will then apply to these transactions, even though, these transactions would not be characterized as giving rise to security rights under non-insolvency law (recommendation 202, alternative A).

210. Other States that maintain separately denominated retention-of-title transactions and financial leases nonetheless provide for a rough functional equivalence between these rights and acquisition security rights. In these States, retention-of-title transactions and financial leases are treated as assets owned by the seller or lessor. Accordingly, the provisions of the UNCITRAL Insolvency Guide relating to third-party-owned assets would then apply to these transactions (see recommendation 202, alternative B).

211. These alternatives can have very different results in insolvency proceedings, especially where reorganization is a possibility. In States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases are treated in the grantor's insolvency in the same way as non-acquisition security rights, with recognition given to any special priority status accorded to the acquisition security rights under non-insolvency law. In these States, typically the insolvency representative can use, sell or lease the encumbered assets so long as it gives substitute security to the secured creditor or the value of the secured creditor's right in the property is otherwise protected against diminution. In such situations, any portion of the secured obligations in excess of the value of the secured creditor's right in the assets is treated as a general unsecured claim, and in the grantor's reorganization the secured creditor's claim, up to the value of the security right, can be restructured (as is the case with other non-acquisition security rights) with a different maturity, payment schedule, interest rate and the like (see chapter XII on the impact of insolvency on a security right, paras. 64-66).

212. The above discussion illustrates that in States where retention-of-title transactions and financial leases are not treated as secured transactions, the insolvency representative often has the right, within a prescribed time period and if willing and able to do so, to perform the contract by: (a) paying the outstanding balance of the price and bringing the asset into the estate; or (b) continuing to pay the lease payments as they come due. In some cases, the insolvency representative can assign the contract, together with the right to use the property, to a third party (which in the case of a lease may require the consent of the lessor). Alternatively, the insolvency representative may be able to reject the

contract, return the property and claim the return of the part of the purchase price paid by the buyer subject to a deduction for depreciation and use prior to the insolvency. In the case of a lease, the insolvency representative may reject the lease agreement for the future and return the asset to the lessor. However, if the asset is critical to the success of the buyer's reorganization, only the first option (performance of the contract as agreed) would in practice be available to the insolvency representative. The need for the insolvency representative to perform the contract as agreed may, for example, in cases where the current value of equipment is less than the balance of the purchase price, result in other assets of the insolvency estate being used to satisfy that performance rather than being used to fund other aspects of the reorganization of the grantor.

213. In States where assets subject to retention-of-title rights and financial lease rights are treated as third-party-owned assets, retention-of-title sellers and financial lessors will have stronger rights at the expense of other creditors in the insolvency proceedings. This inevitably will have an impact on the capacity of the insolvency representative to pursue reorganization. As a consequence, States that adopt the non-unitary approach to acquisition financing in non-insolvency situations must also consider whether this characterization of retention-of-title rights, financial lease rights and similar rights should be maintained in insolvency proceedings. The legislative choice is whether encouraging the supply and financing of equipment or inventory by providing special rights for retention-of-title sellers and financial lessors should outweigh insolvency policies that seek to promote reorganization.

B. Recommendations 178-202

Option A: Unitary approach*

Purpose

The purpose of provisions on acquisition security rights is:

- (a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit, especially for small- and medium-sized businesses;
- (b) To provide for equal treatment of all providers of acquisition financing; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing.

An acquisition security right as a security right

178. The law should provide that an acquisition security right is a security right. Thus, all the recommendations governing security rights, including those on creation, third-party effectiveness (except as provided in recommendation 179), registration, enforcement and the law applicable to a security right, apply to acquisition security rights. The recommendations on priority also apply (except as provided in recommendations 180-185).

*A State may adopt option A (unitary approach), that is, recommendations 178-186, or option B (non-unitary approach), that is, recommendations 187-202. The recommendations outside this chapter are generally applicable to acquisition financing except to the extent modified by the recommendations in this chapter.

Third-party effectiveness and priority of an acquisition security right in consumer goods

179. The law should provide that an acquisition security right in consumer goods is effective against third parties upon its creation and, except as provided in recommendation 181, has priority as against a competing non-acquisition security right created by the grantor.

Priority of an acquisition security right in a tangible asset

180. The law should provide that, except as provided in recommendation 181:

Alternative A*

(a) An acquisition security right in a tangible asset other than inventory or consumer goods has priority as against a competing non-acquisition security right created by the grantor (even if a notice with respect to that security right was registered in the general security rights registry before registration of a notice with respect to the acquisition security right), provided that:

- (i) The acquisition secured creditor retains possession of the asset; or
- (ii) A notice with respect to the acquisition security right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] after the grantor obtains possession of the asset;

(b) An acquisition security right in inventory has priority as against a competing non-acquisition security right created by the grantor (even if that security right became effective against third parties before the acquisition security right became effective against third parties), provided that:

- (i) The acquisition secured creditor retains possession of the inventory; or
- (ii) Before delivery of the inventory to the grantor:
 - a. A notice with respect to the acquisition security right is registered in the general security rights registry; and
 - b. A secured creditor with an earlier-registered non-acquisition security right created by the grantor in inventory of the same kind is notified by the acquisition secured creditor that it has or intends to acquire an acquisition security right. The notice must describe the inventory sufficiently to enable the non-acquisition secured creditor to identify the inventory that is the object of the acquisition security right;

(c) A notice, sent pursuant to subparagraph (b) (ii) b. of this recommendation, may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction. The notice is sufficient only for security rights in tangible assets of which the grantor obtains possession within a period of [a period of time, such as five years, to be specified] after the notice is given.

Alternative B

An acquisition security right in a tangible asset other than consumer goods has priority as against a competing non-acquisition security right created by the grantor (even if a notice of that security right was registered in the general security rights registry before registration of a notice of the acquisition security right), provided that:

- (a) The acquisition secured creditor retains possession of the asset; or
- (b) A notice relating to the acquisition security right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] after the grantor obtains possession of the asset.

*A State may adopt alternative A or alternative B of recommendation 180.

Priority of a security right registered in a specialized registry or noted on a title certificate

181. The law should provide that the priority of an acquisition security right under recommendation 179 or 180 does not override the priority of a security right or other right registered in a specialized registry or noted on a title certificate as provided in recommendations 77 and 78 (chapter V on the priority of a security right).

Priority between competing acquisition security rights

182. The law should provide that the priority between competing acquisition security rights is determined according to the general priority rules applicable to non-acquisition security rights, unless one of the acquisition security rights is an acquisition security right of a supplier that was made effective against third parties within the period specified in recommendation 180, in which case the supplier's acquisition security right has priority as against all competing acquisition security rights.

Priority of an acquisition security right as against the right of a judgement creditor

183. The law should provide that an acquisition security right that is made effective against third parties within the period specified in recommendation 180 has priority as against the rights of an unsecured creditor that would otherwise have priority as provided in recommendation 84 (chapter V on the priority of a security right).

Priority of an acquisition security right in an attachment to immovable property as against an earlier registered encumbrance on the immovable property

184. The law should provide that an acquisition security right in a tangible asset that becomes an attachment to immovable property has priority as against third parties with existing rights in the immovable property (other than an encumbrance securing a loan financing the construction of the immovable property), provided that notice of the acquisition security right is registered in the immovable property registry not later than [a short time period, such as 20-30 days, to be specified] days after the asset becomes an attachment.

Priority of an acquisition security right in proceeds of a tangible asset

185. The law should provide that:

Alternative A*

(a) An acquisition security right in proceeds of a tangible asset other than inventory or consumer goods has the same priority as the acquisition security right in that asset.

(b) A security right in proceeds of inventory has the same priority as the acquisition security right in that inventory, except where the proceeds take the form of receivables, negotiable instruments, rights to payment of funds credited to a bank account or rights to receive the proceeds under an independent undertaking. However, this priority is conditional on the acquisition secured creditor notifying secured creditors that, before the proceeds arise, it registered a notice with respect to a security right in assets of the same kind as the proceeds.

*A State may adopt alternative A of recommendation 185, if it adopts alternative A of recommendation 180, or alternative B of recommendation 185, if it adopts alternative B of recommendation 180.

Alternative B

if an acquisition security right in a tangible asset is effective against third parties, the security right in proceeds has the priority of a non-acquisition security right.

Acquisition security right as a security right in insolvency proceedings

186. The law should provide that, in the case of insolvency proceedings with respect to the debtor, the provisions that apply to security rights apply also to acquisition security rights.

Option B: Non-unitary approach***Purpose**

The purpose of provisions on acquisition financing, including acquisition security rights, retention-of-title rights and financial lease rights, is:

- (a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit especially for small- and medium-sized businesses;
- (b) To provide for equal treatment of all providers of acquisition financing; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing.

Methods of acquisition financing

187. The law should provide that:

- (a) The regime of acquisition security rights in the context of the non-unitary approach is identical to that adopted in the context of the unitary approach;
- (b) All creditors, both suppliers and lenders, may acquire an acquisition security right in conformity with the regime governing acquisition security rights;
- (c) Acquisition financing based on retention-of-title rights and financial lease rights may be provided in accordance with recommendation 188; and
- (d) A lender may acquire the benefit of a retention-of-title right and a financial lease right through an assignment or subrogation.

Equivalence of a retention-of-title right and a financial lease right to an acquisition security right

188. The law should provide that the rules governing acquisition financing produce functionally equivalent economic results regardless of whether the creditor's right is a retention-of-title right, a financial lease right or an acquisition security right.

Effectiveness of a retention-of-title right and a financial lease right

189. The law should provide that a retention-of-title right or a financial lease right in a tangible asset is not effective unless the sale or lease agreement is concluded in or evidenced by a writing that, in conjunction with the course of conduct between the parties, indicates the seller's or the

*A State may adopt option A (unitary approach), that is, recommendations 178-186, or option B (non-unitary approach), that is, recommendations 187-202.

lessor's intent to retain ownership. The writing must exist not later than the time when the buyer or lessee obtains possession of the asset.

Right of buyer or lessee to create a security right

190. The law should provide that a buyer or lessee may create a security right in a tangible asset that is the object of a retention-of-title right or a financial lease right. The maximum amount realizable under the security right is the asset's value in excess of the amount owing to the seller or financial lessor.

Third-party effectiveness of a retention-of-title right or financial lease right in consumer goods

191. The law should provide that a retention-of-title right or a financial lease right in consumer goods is effective against third parties upon conclusion of the sale or lease provided that the right is evidenced in accordance with recommendation 189.

Third-party effectiveness of a retention-of-title right or financial lease right in a tangible asset

192. The law should provide that:

Alternative A*

(a) A retention-of-title right or a financial lease right in a tangible asset other than inventory or consumer goods is effective against third parties only if:

- (i) The seller or lessor retains possession of the asset; or
- (ii) A notice relating to the right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] days after the buyer or lessee obtains possession of the asset;

(b) A retention-of-title right or a financial lease right in inventory is effective against third parties only if:

- (i) The seller or lessor retains possession of the inventory; or
- (ii) Before delivery of the inventory to the buyer or lessee:
 - a. A notice relating to the right is registered in the general security rights registry; and
 - b. A secured creditor with an earlier registered non-acquisition security right created by the buyer or lessee in inventory of the same kind is notified by the seller or lessor of its intention to claim a retention-of-title right or a financial lease right. The notice should describe the inventory sufficiently to enable the secured creditor to identify the inventory that is the object of the retention-of-title right or the financial lease right;

(c) A notice sent pursuant to subparagraph (b) (ii) b. of this recommendation may cover retention-of-title rights and financial lease rights under multiple transactions between the same parties without the need to identify each transaction. The notice is effective only for rights in tangible assets of which the buyer or lessee obtains possession within a period of [a period of time, such as five years, to be specified] years after the notice is given.

*A State may adopt alternative A or alternative B of recommendation 192.

Alternative B

a retention-of-title right or financial lease right in a tangible asset other than consumer goods is effective against third parties only if:

- (a) The seller or lessor retains possession of the asset; or
- (b) A notice relating to the right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] days after the buyer or lessee obtains possession of the asset.

The rule in this recommendation applies also to an acquisition security right in a tangible asset other than consumer goods.

One registration sufficient

193. The law should provide that registration of a single notice in the general security rights registry is sufficient to achieve third-party effectiveness of a retention-of-title right or a financial lease right under multiple transactions between the same parties, whether concluded before or after the registration, which involve tangible assets that fall within the description contained in the notice. The provisions on the registry system apply, with appropriate modifications as to terminology, to the registration of a retention-of-title right and a financial lease right.

Effect of failure to achieve third-party effectiveness of a retention-of-title right or a financial lease right

194. The law should provide that, if a retention-of-title right or a financial lease right is not effective against third parties, ownership of the asset as against third parties passes to the buyer or lessee, and the seller or lessor has a security right in the asset subject to the recommendations applicable to security rights.

Third-party effectiveness of a retention-of-title right or financial lease right in an attachment to immovable property

195. The law should provide that a retention-of-title right or a financial lease right in a tangible asset that becomes an attachment to immovable property is effective against third parties with rights in the immovable property that are registered in the immovable property registry only if it is registered in the immovable property registry not later than [a short time period, such as 20-30 days, to be specified] days after the asset becomes an attachment.

196. The law should provide that, if a seller or lessor fails to register a notice of its retention-of-title right or financial lease right in a tangible asset that became an attachment to immovable property within the time period provided in recommendation 195, retention-of-title right of the seller or the financial lease right of the lessor is deemed to be a security right.

Existence of a security right in proceeds of a tangible asset subject to a retention-of-title right or financial lease right

197. The law should provide that a seller or lessor with a retention-of-title right or financial lease right in a tangible asset has a security right in proceeds of the asset.

Third-party effectiveness of a security right in proceeds of a tangible asset subject to a retention-of-title right or financial lease right

198. The law should provide that:

(a) A security right in proceeds referred to in recommendation 197 is effective against third parties only if the proceeds are described in a generic way in the registered notice by which the retention-of-title right or financial lease right was made effective against third parties or the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account;

(b) If the proceeds are not described in a generic way in the registered notice or do not consist of the types of asset referred to in subparagraph (a) of this recommendation, the security right in the proceeds is effective against third parties for [a short period of time to be specified] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter III on the effectiveness of a security right against third parties) before the expiry of that time period.

Priority of a security right in proceeds of a tangible asset

199. The law should provide that:

Alternative A*

(a) If a retention-of-title right or financial lease right is effective against third parties, the security right in proceeds referred to in recommendation 197 has priority as against another security right in the same assets.

(b) If a retention-of-title right or financial lease right is effective against third parties, the security right in proceeds of inventory referred to in recommendation 197 has the same priority as a retention-of-title or financial lease right in that inventory, except where the proceeds take the form of receivables, negotiable instruments, rights to payment of funds credited to a bank account and rights to receive the proceeds under an independent undertaking. However, this priority is conditional on the seller or lessor notifying secured creditors that have registered a notice with respect to a security right in assets of the same kind as the proceeds before the proceeds arise.

Alternative B

if a retention-of-title right or financial lease right in tangible assets is effective against third parties, the security right in proceeds referred to in recommendation 197 has the priority of a non-acquisition security right if the security right in the proceeds is effective against third parties as provided in recommendation 198. This rule applies also to the proceeds of a tangible asset subject to an acquisition security right.

Enforcement of a retention-of-title right or a financial lease right

200. The law should provide that:

(a) Rules for the post-default enforcement of a retention-of-title right or a financial lease right in a tangible asset should deal with:

- (i) The manner in which the seller or lessor may obtain possession of the asset;
- (ii) Whether the seller or lessor is required to dispose of the asset and, if so, how;

*A State may adopt alternative A of recommendation 199, if it adopts alternative A of recommendation 192, or alternative B of recommendation 199, if it adopts alternative B of recommendation 192.

- (iii) Whether the seller or lessor may retain any surplus; and
- (iv) Whether the seller or lessor has a claim for any deficiency against the buyer or lessee;

(b) The regime that applies to the post-default enforcement of a security right applies to the post-default enforcement of a retention-of-title right or a financial lease right except to the extent necessary to preserve the coherence of the regime applicable to sale and lease.

Law applicable to a retention-of-title right or a financial lease right

201. The law should provide that the conflict-of-laws provisions that apply to security rights apply also to retention-of-title rights and financial lease rights.

Retention-of-title right or financial lease right in insolvency proceedings

202. The law should provide that, in the case of insolvency proceedings with respect to the debtor,

Alternative A*

the provisions that apply to security rights apply also to retention-of-title rights and financial lease rights.

Alternative B

the provisions of the law of the enacting State that apply to ownership rights of third parties apply also to retention-of-title rights and financial lease rights.

*A State may adopt alternative A or alternative B of recommendation 202.

X. Conflict of laws

A. General remarks

1. Introduction

1. The central purpose of the *Guide* is to assist States in the development of modern secured transactions laws with a view to promoting the availability of secured credit, thus promoting the growth of domestic businesses and generally increasing trade (see Introduction, paras. 1-14). In order to achieve this purpose, a secured transactions law has to facilitate credit both from domestic and foreign lenders and other credit providers. Much of secured transactions law is meant to deal with grantors, secured creditors, third-party obligors and third-party creditors that are all located in the same State. It is also directed to security agreements covering encumbered assets located in this same State, both at the time the security right is created and at all times thereafter. However, a significant part of modern commercial activity is not of this type. Increasingly, secured transactions law involves agreements between or affecting parties located in more than one State, or relating to assets that are meant for export or import, are located in more than one State or are normally used in more than one State. Necessarily, therefore, to achieve comprehensiveness the *Guide* must address a broad range of issues that arise from various types of cross-border transaction.

2. This chapter discusses the rules for determining the law applicable to the creation, effectiveness against third parties, priority as against the rights of competing claimants and enforcement of a security right. These rules, generally referred to as conflict-of-laws rules, also determine the territorial scope of the substantive rules envisaged in the *Guide* (that is, if and when the substantive rules of the State enacting the regime envisaged in the *Guide* apply). For example, if a State has enacted the substantive law rules envisaged in the *Guide* relating to the priority of a security right, those rules will apply to a priority contest arising in the enacting State only to the extent that the relevant conflict-of-laws rule on priority issues points to the laws of that State. Should the relevant conflict-of-laws rule provide that the law governing priority is that of another State, the relative priority of competing claimants will be determined in accordance with the substantive law of that other State. Where an issue is already before a court or other authority in a State (the “forum”), the relevant conflict-of-laws rule will be the rule in effect in that State. Where litigation has not yet commenced and the inquiry is what conflict-of-laws rule would apply if litigation were commenced, in order to determine the applicable law, one must examine the conflict-of-laws rules in effect in all States in which enforcement of the security right is likely to occur, and these rules may point to completely different substantive laws governing the issue in question

3. The conflict-of-laws rules proposed in the *Guide* will apply only if the forum is in a State that has enacted the rules recommended by the *Guide*. They cannot apply in a State that has not enacted those rules. This is so because a State cannot legislate on the conflict-of-laws rules to be applied in another State. The courts or other authorities of the other State apply their own conflict-of-laws rules in order to determine whether to apply their domestic substantive law or the substantive law of another State.

4. The conflict-of-laws rules indicate the State whose substantive law will apply to a situation by identifying the factors that connect the situation to that State (“connecting factors”). The main connecting factors recommended by the *Guide* are the location of the encumbered assets and the location of the grantor of the security right. Thus, in a situation where the connecting factor is the location of the assets, the law applicable will be that of the State where the assets are located.

5. After a security right has been created and has become effective against third parties, a change might occur in one or more connecting factors. For example, if the third-party effectiveness of a security right in inventory located in State A is governed under the conflict-of-laws rules of State A by the law of the location of the inventory, the question arises as to what happens if part of the inventory is subsequently moved to State B (whose conflict-of-laws rules also provide that the law of the location of tangible assets governs the third-party effectiveness of security rights in tangible assets). One approach would be for the security right to continue to be effective in State B without the need to take any further step in State B. Another approach would be to require that a new security right be obtained under the laws of State B. Yet another approach would be for the secured creditor’s pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (for example, 30 days after the goods have been brought into State B). As this is a matter of substantive law rather than conflict of laws, the *Guide* addresses it in chapter III (see chapter III on the effectiveness of a security right against third parties, paras. 117-119, and recommendation 45). This chapter deals only with the question of which State’s law will apply to the issue.

6. In an efficient secured transactions regime, conflict-of-laws rules applicable to secured transactions normally reflect the objectives of the secured transactions regime. This means that the law applicable to the property aspects of a security right should be easy to determine. Certainty is a key objective in the development of rules affecting secured transactions, both at the substantive and at the conflict-of-laws levels. Another objective is predictability. As illustrated by the example mentioned in the preceding paragraph, conflict-of-laws rules should provide an answer to the question of whether a security right acquired under the law of State A remains subject to the law of that State or becomes subject to the law of State B if a subsequent change in the connecting factor were to point to the law of State B for a security right of the same type. A third key objective of an efficient conflict-of-laws system is that the relevant rules should reflect the reasonable expectations of interested parties (that is, creditor, grantor, debtor and third parties). In order to achieve this result, the connecting factor that indicates the law applicable to a security right must have some real relation to the factual situation that will be governed by such law.

7. Use of the *Guide* (including this chapter) in developing secured transactions laws will help to reduce the risks and costs resulting from divergences among current conflict-of-laws regimes. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place, including in a jurisdiction administering insolvency proceedings with respect to the grantor and its assets. If those States have different conflict-of-laws rules for the same type of encumbered asset, the creditor will need to comply with more than one regime in order to be fully protected. This, of course, is likely to have a negative effect on the availability and the cost of credit. A benefit of different States having harmonized their conflict-of-laws rules is that a creditor can rely on the same conflict-of-laws rule (leading to the same

results) to determine the status of its security in all those States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention.¹

8. Conflict-of-laws rules would be necessary even if all States had harmonized their substantive secured transactions laws. There would remain instances where the parties would have to identify the State whose requirements will apply. For example, if the laws of all States provided that a non-possessory security right is made effective against third parties by registration of a notice in a public registry, one would still need to know in which State's registry the registration must be made.

9. This chapter discusses, in section A.2, the conflict-of-laws rules for the creation, third-party effectiveness and priority of a security right in general. Section A.3 reviews the law applicable to the creation, third-party effectiveness and priority of a security right in tangible assets, while section A.4 considers the law applicable to the creation, third-party effectiveness and priority of a security right in intangible assets and section A.5 discusses the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds. The chapter then considers, in section A.6, the law applicable to the rights and obligations of the parties to the security agreement and, in section A.7, the law applicable to the rights and obligations of third-party obligors. The law applicable to the enforcement of a security right is commented on in section A.8. The last three sections of section A of the chapter deal with the rules and relevant time for the determination of location (section A.9), public policy and internally mandatory rules (section A.10) and the impact of the commencement of insolvency proceedings to the law applicable to a security right (section A.11). Section B deals with special rules when the applicable law is the law of a multi-unit State. The chapter concludes, in section C, with a series of recommendations.

2. Scope of conflict-of-laws rules

10. This chapter does not define the security rights to which the conflict-of-laws rules will apply. Normally, the characterization of a right as a security right for conflict-of-laws purposes will reflect the substantive secured transactions law in a State. In principle, a court or other authority will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule. The question arises, however, as to whether the conflict-of-laws rules of a State relating to security rights should also apply to other transactions that are functionally similar to security rights, even if they are not covered by the substantive secured transactions regime of that State (for example, retention-of-title sales, financial leases and other similar transactions). The fact that the substantive secured transactions law of a State might not apply to those other transactions should not preclude the State from applying to those transactions the conflict-of-laws rules applicable to security rights. The *Guide* recommends this approach to a State that adopts the non-unitary approach to acquisition financing (see recommendation 201).

11. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation, third-party effectiveness and priority of the transfer be the same as for a security right in the same type of asset. An

¹See Introduction, footnote 7.

example is found in the United Nations Assignment Convention, which, in both its substantive and conflict-of-laws rules, applies to outright transfers of receivables as well as to security rights in receivables (see article 2, paragraph (a), of the Convention). This policy choice is motivated, notably, by the necessity of referring to one single law to determine priority between competing claimants with a right in the same receivable. The *Guide* recommends the same policy (see recommendation 208). Otherwise, in the event of a priority dispute between a purchaser of a receivable and a creditor with a security right in the same receivable, it would be more difficult (and sometimes impossible) to determine who is entitled to priority if the priority of the purchaser were governed by the law of State A but the priority of the secured creditor were governed by the law of State B.

12. Whatever decision a State makes with respect to the range of transactions covered by the conflict-of-laws rules, the scope of those rules on creation, third-party effectiveness and priority of a security right will be confined to the property aspects of the relevant transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the requirements to be met for a property right to be created in the encumbered assets. The rule would not apply to the personal obligations of the parties under their contract. In most States, purely contractual obligations arising from a commercial transaction are generally subject to the law chosen by the parties in their security agreement or, in the absence of such a choice, by the law governing the security agreement as determined by the conflict-of-laws rules of the relevant State (for example, the Convention on the Law Applicable to Contractual Obligations, concluded in Rome in 1980, hereinafter the “Rome Convention”). The *Guide* recommends the same approach to the law applicable to the determination of the mutual rights and obligations of the grantor and the secured creditor with respect to a security right (see recommendation 216).

13. A corollary to recognizing party autonomy with respect to the personal obligations of the parties is that the conflict-of-laws rules applicable to the property aspects of secured transactions are matters that are outside the domain of freedom of contract. For example, the grantor and the secured creditor are normally not permitted to select the law applicable to priority, since this could not only affect the rights of third parties, but could also result in a priority contest between two competing security rights being subject to two different laws leading to opposite results.

14. The conflict-of-laws rules of many States now provide that reference to the law of another State as the law governing an issue refers to the law applicable in that State other than its conflict-of-laws rules. The doctrine of *renvoi* (under which a State’s law includes its conflict-of-laws rules) is excluded, for the sake of predictability and also because *renvoi* may lead to results that run contrary to the expectations of the parties. The *Guide* recommends the same approach (see recommendation 221).

3. *Conflict-of-laws rules for the creation, third-party effectiveness and priority of a security right*

15. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis, as follows:

(a) The first issue is whether the security right has been created (for matters covered by the concept of creation, see chapter II);

(b) The second issue is whether the security right is effective against third parties (for matters covered by the concept of third-party effectiveness and registration, see chapters III and IV); and

(c) The third issue is to determine what is the priority ranking of the right of a secured creditor as against the right of a competing claimant, such as another creditor or the grantor's insolvency representative (for matters covered by the concept of priority, see chapter V).

16. A security right is, no doubt, of little practical value if it cannot be efficiently enforced. The question of enforcement does not, however, relate to the extent of the rights that the secured creditor has in the encumbered assets. The conflict-of-laws rules on enforcement will be discussed in another section of this chapter (see paras. 64-72 below).

17. Not all States draw a distinction between the three issues already mentioned (see para. 15 above). In many States, a security right (or other property right) once created is by definition effective against all parties (*erga omnes*) without any further action. In those States, the same conflict-of-laws rule applies to the creation of a security right and its effectiveness against third parties. Likewise, priority may be analysed as an issue of effectiveness. However, even States that clearly distinguish among effectiveness as between the parties (creation), effectiveness against third parties and priority do not always establish a separate conflict-of-laws rule for each of those issues; thus the same conflict-of-laws rule may apply to each of the three issues resulting in the substantive law of the same State being applicable to all such issues.

18. Therefore, the key question is whether one single conflict-of-laws rule should apply to all three issues. Policy considerations, such as simplicity and certainty, favour the application of a single rule. As noted above, the distinction among these issues is not always made or understood in the same manner in all States, with the result that providing different conflict-of-laws rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding statutory security or a judgement creditor or an insolvency representative.

19. Another important question is whether, on any given issue (that is, creation, third-party effectiveness or priority), the relevant conflict-of-laws rule should be the same for tangible and intangible assets. A positive answer to that question would favour either a rule based on the law of the location of the encumbered assets (*lex situs* or *lex rei sitae*) or a rule based on the law of the location of the grantor.

20. In the case of receivables, an approach based on the *lex situs* would be inconsistent with the United Nations Assignment Convention (article 22 of which refers to the law of the State in which the assignor is located). Moreover, as intangible assets are not capable of physical possession, adopting the *lex situs* as the applicable conflict-of-laws rule would require the development of special rules and legal fictions for the determination of the actual location of various types of intangible asset. For this reason, the *Guide* does not consider the location of the asset as being the appropriate connecting factor for intangible assets and favours an approach generally based on the law of the location of the grantor (see recommendation 208).

21. In addition, consistency with the United Nations Assignment Convention would dictate defining the location of the grantor in the same way as in the Convention (see recommendation 219). Under the Convention, the grantor's location is its place of business or, if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see article 5, subparagraph (h), of the Convention). This definition was adopted in the Convention primarily because that location was considered as being the real location of the grantor and also because it leads to the law of the State in which the main insolvency proceedings with respect to the grantor would most likely be opened (as to the meaning of a main proceeding, see, for example, articles 2, subparagraph (b), and 16, paragraph 3 of the UNCITRAL Model Law on Cross-Border Insolvency).

22. Simplicity and certainty considerations could even support the adoption of the same conflict-of-laws rule (that is, the law of the grantor's location) not only for intangible assets but also for tangible assets, especially if the same law were to apply to the creation, third-party effectiveness and priority of a security right. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all the assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right in the same assets governed by the law of State B).

23. Not all States, however, regard the law of the location of the grantor as sufficiently connected to security rights in tangible assets, at least for "non-mobile" assets (or even in certain types of intangible asset, such as rights to payment of funds credited to a bank account or intellectual property). Moreover, in many cases, adoption of the law of the grantor's location would result in one law governing a secured transaction and another law governing a transfer of ownership in the same assets. To avoid this result, States would need to adopt the grantor's-location law for all transfers of ownership.

24. In addition, it is almost universally accepted that a possessory security right should be governed by the law of the place where the assets are held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of secured creditors. Accordingly, even if the law of the grantor's location were to be the general rule, an exception would need to be made for possessory security rights.

25. For all these reasons, the *Guide* recommends two general conflict-of-laws rules on the law applicable to the creation, third-party effectiveness and priority of a security right, as follows:

(a) With respect to tangible assets, the applicable law should be the law of the location of the assets (see recommendation 203);

(b) With respect to intangible assets, the applicable law should be the law of the location of the grantor (see recommendation 208).

26. As the conflict-of-laws rules generally will be different depending on the tangible or intangible character of the assets, the question arises as to which conflict-of-laws rule is

appropriate where intangible assets are capable of being the subject of a possessory security right. In this regard, most States assimilate certain categories of rights embodied in a document (such as a negotiable instrument) to tangible assets, thereby recognizing that a possessory security right may be created in such assets through the delivery of the document to the creditor. The *Guide* treats these types of intangible asset as tangible assets and, accordingly, the conflict-of-laws rule for tangible assets generally applies to such intangible assets. Thus, in the case of a negotiable instrument, the law of the State where the instrument is held will govern the creation, third-party effectiveness and priority of a security right in the negotiable instrument (see recommendation 203).

27. A similar issue arises where tangible assets are represented by a negotiable document of title (such as a bill of lading). It is generally accepted that a negotiable document of title is also assimilated to a tangible asset and may be the subject of a possessory security right. The law of the location of the document, and not of the actual tangible assets covered thereby, would then govern the security right. The question arises, however, as to what law would apply to resolve a priority contest between a creditor with a security right in a document of title and another creditor to whom the debtor might have granted a non-possessory security right in the tangible assets themselves, if the document and the tangible assets are not held in the same State. In such a case, the conflict-of-laws rules should accord precedence to the law governing the security right in the document on the basis that this solution would better reflect the legitimate expectations of interested parties (see recommendation 206). This result would also be consistent with the substantive law rules proposed by the *Guide* on the creation, third-party effectiveness and priority of a security right in a negotiable document (see recommendations 28, 52 and 108).

4. *Law applicable to the creation, third-party effectiveness and priority of a security right in a tangible asset*

28. The policy considerations favouring the general conflict-of-laws rules set out above do not necessarily apply in all circumstances and other rules may apply with respect to certain specified types of asset for which the location of the asset or of the grantor is not the most appropriate connecting factor. In addition, for the sake of efficiency, alternative rules apply with respect to assets in transit and assets intended for export. Such assets are not intended to remain in their initial location and may cross the borders of several States before reaching their ultimate destination. The following paragraphs explain the two general conflict-of-laws rules outlined above and their exceptions.

(a) *General rule: law of the location of the encumbered asset* (*lex situs or lex rei sitae*)

29. As mentioned above, the creation, the effectiveness against third parties and the priority of a security right in tangible assets are generally governed by the law of the State in which the encumbered asset is located (see recommendation 203). A frequent example of the application of this rule relates to security rights in inventory. If a grantor owns inventory located in a State that has this rule (State A), the law of that State will govern those issues. The rule also means that, if the grantor also owns other inventory in another State (State B), the relevant requirements of State B will have to be fulfilled in order for

the courts of State A to recognize that the inventory located in State B is subject to the secured creditor's rights.

30. The general conflict-of-laws rule for tangible assets does not distinguish between possessory security rights and non-possessory security rights. Accordingly, the law of the location of the asset will generally apply whether or not the secured creditor has possession of the asset. As already discussed (see paras. 26 and 27 above), this is particularly relevant for intangible assets assimilated to tangible assets, such as negotiable instruments and negotiable documents. For example, the law of the location of the negotiable instrument or document will govern priority matters even if the security right is made effective against third parties otherwise than by possession.

(b) *Additional rule for the creation and third-party effectiveness of a security right in assets in transit or to be exported*

31. With respect to assets in transit or assets intended for export, application of the law of the location of the assets results in the application of the law of the State in which the assets are located at the time an issue arises. A consequence of the rule is that secured creditors need to monitor the assets and follow the requirements of each State in which the assets may be located to ensure that they have an effective security right at all times. To avoid that burden, one approach would be for the State of the ultimate and each intermediate destination to recognize as effective a security right created and made effective against third parties under the law of the initial location. Such an approach would reflect the expectations of parties in the initial location of the assets, but would be contrary to the expectations of parties that provided credit to the grantor in accordance with the requirements of the law of the ultimate destination of the assets.

32. Another approach would be for the State of the ultimate destination to recognize for a limited period of time a security right created and made effective against third parties under the law of the initial location of the assets. Parties in the initial location could then have a period of time to follow the third-party effectiveness requirements of the law of the State of the ultimate destination to preserve the effectiveness originally acquired in the initial location. Such an approach would balance the interests of parties in the various jurisdictions (and is in fact supported by the *Guide* for most types of tangible asset; see recommendations 45 and 203).

33. A further approach would be to offer to the secured creditor the option of creating its security right and making it effective against third parties under the law of the State of the initial location of the assets or under the law of the State of the ultimate location of the assets, provided, in the latter case, that the assets reach such location within a specified period of time (see recommendation 207). This approach would allow a secured creditor that is confident that the assets will reach the place of their intended destination to rely on the law of that place to create its security right and make it effective against third parties. A rule providing for that option is particularly useful when the assets are likely to transit quickly through other States and arrive at their final destination within a short period of time after shipment. Otherwise, in the case of a security right created while the assets are at their initial location, for the security right to be continuously effective against third parties, the secured creditor would have to fulfil the third-party effectiveness requirements of

the place of the initial location, of each State where the assets could be in transit and of the place of the ultimate destination. In any case, priority would always be subject to the law of the location of the assets at the time a priority dispute arises.

(c) *Special rule for the third-party effectiveness of a security right in a negotiable instrument*

34. As mentioned above, it is generally accepted that the law of the State in which a negotiable instrument is located (*lex situs*) should govern the creation, third-party effectiveness and priority of a security right in the instrument (see recommendation 203). However, in some States, the third-party effectiveness of a security right in a negotiable instrument may also be achieved by registration in the place in which the grantor is located. In such a case, it is logical to rely on the law of the State of the grantor's location to determine whether third-party effectiveness has been achieved by registration (see recommendation 211). It is worth noting that this option is confined to third-party effectiveness. The law of the actual location of the negotiable instrument will always govern the creation and priority of a security right in the instrument.

(d) *Exceptions to the lex situs rule for mobile assets and tangible assets subject to a specialized registration system*

35. The general conflict-of-laws rule for security rights in tangible assets is normally subject to certain exceptions where the location of the assets would not be an efficient connecting factor (for example, assets ordinarily used in several States) or would not correspond to the reasonable expectations of the parties (for example, assets the ownership of which must be recorded in special registries).

(i) *Mobile assets*

36. Mobile assets, such as aircraft, ships, motor vehicles and, in some cases, machinery, are assets that in the normal course of business cross the borders of States. For example, a grantor operating a construction business in several States may have to create security rights in machinery periodically moved from one State to another for the purposes of that business; or a grantor operating a transportation business may need to create security rights in the motor vehicles used in the transportation business (although motor vehicles may not normally cross national borders in island States). The application to mobile assets of the general conflict-of-laws rule for tangible assets (that is, the *lex situs*) would require the secured creditor to ascertain the exact location of each piece of machinery or each motor vehicle at the time of the creation of the security right. To ensure continued third-party effectiveness of its security right, the secured creditor would also need to enquire as to the requirements of all States in which each of these assets might potentially be located at any given time and meet the relevant requirements of all such States. Moreover, it would not be possible to identify the State in which the relevant asset would be located at the time of a priority contest occurring in the future and therefore to determine the regime to be applied to resolve the dispute. To avoid these problems and resulting costs and uncertainties, in some States, the creation, third-party effectiveness and priority of a

security right in tangible assets of a type ordinarily used in more than one State is governed by the law of the State in which the grantor is located (except if ownership of assets of that type is subject to registration in a special registry which also allows for the registration of security rights; see paras. 37 and 38 below). The *Guide* recommends this approach (see recommendation 204).

(ii) *Tangible assets, rights in which are subject to specialized registration or notation on a title certificate*

37. The ownership of certain categories of tangible assets is sometimes recorded in specialized registries or evidenced by a title certificate. This is generally the case for aircraft and ships and, in some States, for motor vehicles. To the extent that the relevant registry or notation system also permits the registration or notation of security rights, reference can be made to the law of the State under the authority of which the relevant registry is maintained, or the title certificate is issued, to determine the law governing the creation, third-party effectiveness and priority of a security right in an asset when rights in that asset are subject to registration in such a specialized registry or notation on a title certificate. Thus, a search in the registry or an examination of the title certificate would disclose both ownership and security rights in respect of such assets. Such a rule may be based on national law (see recommendation 205) or international conventions, which take precedence (for example, the Convention on International Interests in Mobile Equipment and the relevant protocols thereto).

38. For the rule to work efficiently, however, the asset must be of a type where rights in the asset are generally recognized as being the subject of registration in a specialized registration or title certificate system that is easy to locate. Otherwise, a prospective lender would have to investigate the substantive law of all the States in which an asset might have been located in the past to determine whether such a specialized registration or title certificate system is maintained in any of those States. In addition, the rule should not apply to an asset when rights in the asset may be registered in specialized registries or title certificate systems in more than one State; in such a case, the rule would provide no guidance as to the law applicable to a dispute. For these reasons, some States might prefer to abstain from adopting this rule in instances not governed by international conventions.

5. *Law applicable to the creation, third-party effectiveness and priority of a security right in an intangible asset*

(a) *General rule: law of the location of the grantor*

39. In some States, the creation, third-party effectiveness and priority of a security right in intangible assets is governed by the law of the State in which the grantor is located. For example, if an exporter located in State A creates a security right in receivables owed by customers located in States B and C, the law of State A will govern the property right aspects of the security right. This rule is consistent with the approach followed in the United Nations Assignment Convention with respect to the law applicable to the assignment of receivables (see articles 22 and 30 of the Convention).

40. In other States, the law of the location of the asset (*lex situs*) still governs the creation, third-party effectiveness and priority of a security right in intangible assets. In those States, it is necessary to establish the location of an intangible asset (for example, in the case of a receivable, the location of the debtor of the receivable).

41. The law of the grantor's location has several advantages over the *lex situs*, especially where the encumbered intangible assets consist of receivables. One single law applies even if the assignment relates to many receivables owed by different debtors. In addition, the law of the grantor's location may be ascertained easily at the time the assignment is made, even if the assignment relates to future receivables or to receivables assigned in bulk. Moreover, the law of the grantor's location (the place of central administration in the case of a grantor having places of business in more than one State) is the law of the State in which the main insolvency proceedings with respect to the grantor are likely to be administered (as to the meaning of a main proceeding, see, for example, articles 2, subparagraph (b), and 16, paragraph 3 of the UNCITRAL Model Law on Cross-Border Insolvency).

42. It is also the case that, while the law of the location of the encumbered asset (*lex situs*) works well in most instances for tangible assets, great difficulties arise in applying the *lex situs* to intangible assets, at both conceptual and practical levels. From a conceptual standpoint, there is no consensus and no clear answer as to the *situs* of a receivable. One view is that it is the place where payment must be made. That place is not, however, always easy to identify, as the contract under which the receivable arises might be silent in this regard (and even if the contract addresses the matter explicitly, the place of payment might not be easy for third parties to determine); then the law would have to specify other means permitting such identification. Another view is that the *situs* of a receivable is the legal domicile or place of business or principal residence of the debtor of the receivable. Any of the foregoing alternatives would impose upon a prospective assignee the burden of having to make a detailed factual and legal investigation. Moreover, in many instances, it might prove impossible for the assignee to determine with certainty the exact location of a receivable since the criteria for determining that location may depend on business practices or the will of the parties to the contract under which the receivable arises. Thus, using the *lex situs* as the law applicable to security rights in receivables would not provide certainty and predictability, which are key objectives for a sound conflict-of-laws regime in the area of secured transactions.

43. Furthermore, even if a State had detailed provisions allowing a prospective or existing secured creditor to ascertain easily and objectively the law of the location of a receivable, practical difficulties would still ensue in many commercial transactions. This would be so because a security right may relate not only to an existing and specifically identified receivable, but also to many other receivables. Thus, a security right may cover a pool of present and future receivables. In such a case, selecting the *lex situs* as the law governing priority would not be an efficient policy decision, as different priority rules might apply with respect to the various assigned receivables. Moreover, where future receivables are subject to a security right, it would not be possible for the secured creditor to ascertain the extent of its priority rights at the time of the assignment, since the *situs* of those future receivables is unknown at that time.

44. Some States avoid the difficulties of applying the *lex situs* to receivables by relying on the law governing the receivable (for example, the law governing the contract under

which the receivable arises). In taking this approach, these States have in mind mainly capital market and similar transactions. A benefit of this approach is that the same law would apply not only to the creation, third-party effectiveness and priority of a security right, but also to the effects of the security right against the debtor of the receivable. This approach also avoids the question of whether a receivable that is not assignable under its governing law might nonetheless be subject to a security right under a different law that allows the creation of a security right over a non-assignable receivable. Finally, this approach has the advantage that it takes away the risk of having a subsequent change in the location of the grantor that would otherwise arise in a situation where the grantor makes an assignment, changes location and makes another assignment.

45. A rule based on the law governing the receivable would work well for a security right in one specifically identified receivable, as well as for a security right in a receivable arising from securities, a financial contract or a foreign exchange transaction, in which it is customary to conduct due diligence on each receivable to be assigned. However, in a bulk assignment involving a large number of receivables (where due diligence on each receivable would be either too costly or impossible), such a rule would raise the same difficulties as an approach based on the *lex situs*, especially where future receivables are covered by the assignment; in the latter case, a secured creditor would have no means of identifying in advance the requirements to be complied with to protect its rights in respect of the future receivables.

46. In view of the above, the *Guide* recommends that, with the exception of security rights in certain intangible assets with respect to which the *Guide* recommends different conflict-of-laws rules (see paras. 48-54 below), the creation, third-party effectiveness and priority of a security right in an intangible asset should be governed in general by the law of the State in which the grantor is located (see recommendation 208). The criteria defining the grantor's location are consistent with those found in the United Nations Assignment Convention (see paras. 21 above and 74 below; see also recommendation 219). The law of the grantor's location rule does not apply to security rights in securities and payment rights arising from or under financial contracts governed by netting agreements or from or under foreign exchange transactions, but for a different reason: the *Guide* does not apply to security rights in such types of asset (see recommendation 4, subparagraphs (c)-(e)).

47. As the purpose of a rule based on the grantor's location is to provide greater certainty with respect to the law applicable, States enacting the *Guide* need to deal with the effect of a change in that location. In such a case, the law of the new location would apply for the purpose of determining the law applicable to third-party effectiveness and priority of a security right, with the exception of a priority contest involving only competing claimants whose rights became effective against third parties before the change in location (see para. 78 below).

(b) *Exceptions to the law of the grantor's location rule for certain types of intangible asset*

48. There are three categories of intangible asset in respect of which different considerations apply and the location of the grantor is not the most (or the only) appropriate connecting factor for the selection of the applicable law. These are: a right to payment of

funds credited to a bank account; a right to receive the proceeds under an independent undertaking; and a receivable arising from a transaction relating to immovable property.

(i) *Rights to payment of funds credited to a bank account*

49. With respect to the creation, third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account, different approaches are followed in various States. For the sake of simplicity and because the right to payment of funds credited in a bank account is a receivable, some States consider that the governing law for receivables in general should also apply to a bank account. Other States follow a different approach, that is, to refer to the law of the State in which the branch maintaining the account is located (see recommendation 210, alternative A). Under this approach, certainty and transparency with regard to the applicable law would be enhanced, as the location of the relevant branch could easily be determined in a bilateral relationship between a bank and its client. In addition, such an approach would reflect the normal expectations of parties to current banking transactions. Moreover, this approach would result in the law governing a security right in a right to payment of funds credited to a bank account being the same as that applicable to regulatory matters. The location of the branch is often viewed as the *situs* of a right to receive payment of funds credited to a bank account for regulatory or other matters in respect of which the *situs* of that right must be ascertained.

50. Another approach is to refer to the law specified in the account agreement as governing the agreement or to any other law explicitly specified in the account agreement, provided that the depositary bank has a branch in the State whose law is so specified. If the account agreement does not specify any law, the applicable law is determined using the same default criteria as those found in article 5 of The Hague Securities Convention (see recommendation 210, alternative B). Under this approach, the applicable law would meet the expectations of the parties to the account agreement. Third parties would be able to ascertain the law provided in the account agreement, as the grantor (the account holder) would normally supply information on the account agreement to obtain credit from a lender relying on the funds credited to the account.

51. As is the case with negotiable instruments and for the same reasons, the law of the State of the grantor's location could apply to the third-party effectiveness of a security right in a right to payment of funds credited to a bank account where third-party effectiveness may be achieved by registration in the place where the grantor has its location (see para. 34 above and recommendation 211).

(ii) *Rights to receive the proceeds under an independent undertaking*

52. In many States, the third-party effectiveness and priority of a security right in a right to receive the proceeds under an independent undertaking are referred to the law specified in the independent undertaking (for this approach, see recommendation 212). If the governing law is not specified in the independent undertaking, those matters are referred to the law of the State of the location of the relevant office of the person that has provided (or has agreed to perform, as the case may be) the undertaking (see recommendation 213).

This law is viewed as being the most closely connected to the undertaking. Its application is also consistent with the normal expectations of parties to such transactions. As to the creation of a security right in such an asset, the general conflict-of-laws rule for security rights in intangible assets (that is, the law of the grantor's location) continues to apply in view of the fact that creation involves only the effectiveness of the security right as between the parties to the security agreement and does not affect the rights of other parties.

53. However, if an independent undertaking is issued to ensure the performance of an obligation under a receivable or negotiable instrument, the law governing the creation and third-party effectiveness of a security right in the receivable or negotiable instrument will determine whether the security right extends automatically to the independent undertaking (see recommendation 214). This approach is justified by the need to apply, for consistency reasons, the same law to the creation and third-party effectiveness of a security right in a receivable or negotiable instrument and in a right to receive the proceeds under a related independent undertaking.

(iii) Receivables related to immovable property

54. Where a receivable arises from the sale or lease of immovable property or is secured by immovable property, as for any other receivable, the law of the State of the location of the grantor should normally govern the property aspects of a security right in the receivable. However, in the event of a priority contest where at least one of the competing claimants has registered its right in the immovable property registry of the State in which the immovable property is located, the *Guide* recommends that the priority contest be resolved in accordance with the law of the State under whose authority the registry is maintained (see recommendation 209). The purpose of the latter rule is to ensure that the law of the State maintaining the registry actually applies to parties that are entitled by that law to rely on the registry. For the same reason, this rule is confined to a situation where, under the law of the State of the registry, registration in the registry is relevant for third-party effectiveness and priority issues.

6. Law applicable to the creation, third-party effectiveness and priority of a security right in proceeds

55. There are generally three approaches to the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds.

56. One approach is to refer, for the law applicable to a security right in proceeds, to the law applicable to the security right in the original encumbered assets. For example, if the original encumbered assets are in the form of inventory located in State A, the proceeds take the form of receivables and the grantor is located in State B, the law of State A would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Hence, a priority conflict between a security right in receivables as proceeds of inventory and a security right in receivables as original encumbered assets would be governed by the law of State A (the law of the location of the inventory). As a result, certainty as to the applicable law would be enhanced for the benefit of the inventory financiers relying on the receivables as proceeds.

57. However, this approach has significant disadvantages for the receivables financier. For example, it would result in the application of a law other than the law receivables financiers would expect to apply to their rights in the receivables as original encumbered assets. Another disadvantage is that the receivables financier would be unable to predict what the applicable law would be because the governing law would depend on whether the dispute arises with an inventory financier (in which case the law of the location of the inventory would govern) or with another competing claimant (in which case the law of the location of the grantor would govern). This approach also provides no solution in a tripartite dispute among the receivables financier, the inventory financier and another competing claimant. This approach would also undermine the choice of the law of the grantor's location as the law applicable to a security right in receivables because receivables often result from the sale of tangible assets. The receivables financier in many instances then would be unable to rely on the law of the grantor's location.

58. A second approach is to refer to the law applicable to security rights in assets of the same type as the proceeds. In the example given above, the law of State B (the law of the grantor's location) would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Simplicity and certainty considerations would support such an approach: it would always be possible to determine the applicable law irrespective of the parties to the dispute.

59. Yet a third approach is to combine the two approaches mentioned above and retain the second approach as the rule for third-party effectiveness and priority of a security right in proceeds, while the first approach would apply to the creation of that right. Under this third approach, the question of whether a security right extends to proceeds would be governed by the law applicable to the creation of a right in the original encumbered assets from which the proceeds arose, while the third-party effectiveness and priority of a security right to proceeds would be subject to the law that would have been applicable to such issues if the proceeds had been original encumbered assets.

60. This approach would meet the expectations of a creditor obtaining a security right in inventory under a domestic law providing that such a security right automatically extends to proceeds. It would also meet the expectations of receivables financiers as to the law that would apply to the creation, third-party effectiveness and priority of a security right in receivables as original encumbered assets. Finally, such an approach would ensure that the inventory financier could rely on the law governing its security right to determine whether the right extends to proceeds and would allow all competing claimants to identify with certainty the law that will govern a potential priority contest. For all these reasons, this is the approach recommended in the *Guide* (see recommendation 215).

7. *Law applicable to the rights and obligations of the parties to the security agreement*

61. As already mentioned (see para. 12 above), the scope of the rules on the creation, third-party effectiveness and priority of a security right is confined to the property (*in rem*) aspects of the security right. These rules do not apply to the mutual rights and obligations of the parties to the security agreement. Such rights and obligations are instead governed by the law chosen by them or, in the absence of a choice of law, by the law governing the

agreement as determined by the conflict-of-laws rules generally applicable to contractual obligations. This is the approach recommended in the *Guide* (see recommendation 216). There are various conflict-of-laws rules applicable to contractual obligations. For example, in a State in which the Rome Convention is in effect, in the absence of a choice of law by the parties, the mutual rights and obligations of the parties to the security agreement will be subject to the law most closely connected to the security agreement (see article 4, paragraph 1, of the Rome Convention). A loan agreement whereby a security right is also granted may be presumed to be most closely connected with the State in which the party that performs the obligation that is characteristic of the agreement has its central administration or habitual residence (see article 4, paragraph 2, of the Rome Convention). In such a loan agreement, this party may be the lender. In a retention-of-title sale, it may be the seller.

8. *Law applicable to the rights and obligations of third-party obligors*

62. Security rights in intangible assets generally involve third parties such as, for example, the debtor of a receivable, an obligor under a negotiable instrument, the depositary bank in the case of a right to payment of funds credited to a bank account, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document. The conflict-of-laws rules governing the property aspects or the enforcement of a security right are not necessarily appropriate for the determination of the law applicable to the obligations of third parties against whom the secured creditor may want to exercise the recourses arising from its security right. Applying these rules would frustrate the expectations of parties that have payment or other obligations arising in connection with the encumbered asset but do not take part in the transaction to which the security agreement relates.

63. In particular, the fact that a receivable has been encumbered by a security right should not result in the obligations of the debtor of the receivable becoming subject to a law different from the law governing the receivable. Similar considerations apply to the obligations of the obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document where a security right has been created in a negotiable instrument, in a right to payment of funds credited to a bank account, in a right to receive the proceeds under an independent undertaking or in a negotiable document. It is generally accepted that the existence of the security right should not displace the law applicable to the relationship of all such parties with the grantor and that such law should also govern their relationship with the secured creditor. The conflict-of-laws rules recommended in the *Guide* follow this approach (see recommendation 217).

9. *Law applicable to the enforcement of a security right*

64. In most States, procedural matters are governed by the law of the State where the relevant procedural step is taken. However, enforcement may relate to substantive or procedural matters. Typically, the forum State will use its own law to determine what is substantive and what is procedural. The following are examples of issues generally considered to be substantive: the nature and extent of the remedies available to the creditor to enforce its security right in the encumbered assets; whether such remedies (or some of

them) may be exercised without judicial process; the conditions to be met for the secured creditor to be entitled to obtain possession and dispose of the assets (or to cause the assets to be judicially disposed of); the power of the secured creditor to collect receivables that are encumbered assets; and the obligations of the secured creditor to other creditors of the grantor.

65. With respect to substantive enforcement matters, where a security right is created and made effective against third parties under the law of one State, but is sought to be enforced in another State, the question arises as to the law applicable to determine the remedies available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security right could allow enforcement by the secured creditor without prior recourse to the judicial system, while the law of the place of enforcement might require advance judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

66. One approach would be to refer enforcement remedies to the law of the place of enforcement, that is, the law of the forum State (the *lex fori*). The place of enforcement of a security right in a tangible asset in most instances would be the State in which the asset is located, while enforcement of a security right in an intangible asset, such as a receivable, might take place in the State in which the debtor of the receivable is located. The policy reasons in favour of this approach are, among others, that:

(a) The law of remedies would coincide with the law generally applicable to procedural issues;

(b) The law of remedies would, in many instances, coincide with the law of the State in which the assets that are the object of the enforcement are located (and could also coincide with the law governing priority if the conflict-of-laws rules of the relevant State point to such location for priority issues); and

(c) The requirements would be the same for all creditors intending to exercise rights in the place of enforcement against the assets of a grantor, irrespective of whether such rights are domestic or foreign in origin.

67. However, selecting the *lex fori* may result in uncertainty if the encumbered asset is an intangible asset. For example, it is not clear where enforcement is to take place if the encumbered asset is a receivable. The answer to this question could be very problematic as it would require the criteria for determining the location of the receivable to be specified in the law (see para. 41 above). In addition, the secured creditor might be located in a different State at the time the initial enforcement steps are taken. In the case of a bulk assignment involving receivables that are owed by debtors located in several States, multiple laws may apply to enforcement. The difficulty would be the same if one enforcement act would have to be performed in one State (for example, notification of the debtor of the receivable) and another act in another State (for example, collection or sale of the receivable). If future receivables are involved, the secured creditor may not know at the time of the assignment which law would govern its enforcement remedies. All this uncertainty as to the applicable law may have a negative impact on the availability and the cost of credit.

68. Another concern is that the *lex fori* might not give effect to the expectations of the parties. The parties' expectations may be that their respective rights and obligations in an

enforcement situation will be those provided by the law under which the priority of the security right will be determined. For example, if extrajudicial enforcement is permitted under the law governing the priority of the security right, this remedy should also be available to the secured creditor in the State where it has to enforce its security right, even if it is not generally allowed under the domestic law of that State.

69. Thus, another approach would be to refer substantive enforcement matters to the law governing the priority of a security right. The advantage of this approach would be that enforcement matters are closely connected with priority issues (for example, the manner in which a secured creditor will enforce its security right may have an impact on the rights of competing claimants). Such an approach may have another benefit. As the law governing priority is often the same law as the law governing the creation and third-party effectiveness of the security right, the final result would be that creation, third-party effectiveness, priority and enforcement issues would often be governed by the same law.

70. A third possible approach would be a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This approach would result in an applicable law that would often correspond to the parties' expectations. In addition, in many instances, under such an approach the applicable law would coincide with the law applicable to the creation of the security right, since that law is also frequently selected as being the law of the contractual obligations of the parties. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum State or the law governing priority. This solution would be disadvantageous to third parties, which may have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the assets of their common debtor. Therefore, referring enforcement issues to the law governing the contractual relationship of the parties would necessitate exceptions designed to take into account the interests of third parties, as well as the mandatory rules of the forum State or of the law governing creation, third-party effectiveness and priority.

71. A fourth approach would be to attempt to reconcile the benefits of the approaches based on the law of the place of enforcement (*lex fori*) and the law governing priority. Under this approach, the enforcement of a security right in tangible assets may be governed by the *lex fori*, while the enforcement of a security right in intangible assets would be governed by the same law as the law that applies to priority. The *Guide* recommends this solution as it preserves the benefits of using the *lex fori* for tangible assets, while avoiding the difficulties that would arise if such law were to apply to intangible assets (see recommendation 218).

72. It must be noted that the above conflict-of-laws rules on enforcement do not govern the relationship between a secured creditor and third-party obligors. As already mentioned (see paras. 62-63 above), the obligations of such persons to the secured creditor are generally governed by the same law that is applicable to their relationship to the grantor. In addition, the conflict-of-laws rules on enforcement are designed only to govern substantive issues and do not apply to procedural matters (which, in some States, could arise only in the case of judicial enforcement).

10. Rules and relevant time for the determination of location

73. As the general conflict-of-laws rules for security rights in tangible and intangible assets point to the location of the encumbered assets and to the location of the grantor, respectively, it is essential that the appropriate location be easily identified. Tangible assets are commonly viewed as being located at the place where they are physically located and there is no need to provide a specific rule to that effect. There is such a need, however, for the determination of the location of the grantor. The legal domicile and the residence of a natural person might be in different States. Likewise, a legal person may have its statutory head office in a State other than the State in which its principal place of business or decision centre is located.

74. As mentioned above, the United Nations Assignment Convention defines the location of the grantor as follows: the grantor is located in the State in which it has its place of business or, if the grantor has places of business in more than one State, in the State in which the grantor exercises its central administration. If the grantor has no place of business, reference is made to the State in which the grantor has its habitual residence (see article 5, subparagraph (h)). The *Guide* defines the location of the grantor in the same manner (see recommendation 219).

75. Whatever connecting factor is retained for determining the most appropriate conflict-of-laws rule for any given issue, there may be a change in the relevant factor after a security right has been created. For example, where the applicable law is that of the State where the grantor has its head office, the grantor might later relocate its head office to another State. Similarly, where the applicable law is the law of the State where the encumbered assets are located, the assets may be moved to another State. Thus, it is also necessary to determine the time that is relevant for the determination of location.

76. If this issue is not dealt with specifically, the general conflict-of-laws rules on creation, third-party effectiveness and priority of a security right might be construed to mean that, in the event of a change in the relevant connecting factor, the original governing law continues to apply to creation issues (because they arose before the change), while the subsequent governing law would apply to events occurring thereafter that raise third-party effectiveness or priority issues. For example, in a situation where the law applicable to the third-party effectiveness of a security right is that of the grantor's location, the effectiveness of the right against the grantor's insolvency representative would be determined using the law of the State of the new location of the grantor at the time of commencement of the insolvency proceedings.

77. Silence of the law on these matters might, however, give rise to other interpretations. For example, one interpretation might be that the subsequent governing law also governs creation as between the parties in the event of a priority dispute occurring after the change. The rationale is that third parties dealing with the grantor are entitled to determine the applicable law for all issues by relying on the actual connecting factor being the connecting factor in effect at the time of their dealings.

78. Thus, providing guidance on these issues is necessary in order to allow interested parties to determine with certainty whether a change in the connecting factor would result in the application of a law other than the law initially expected by the parties to apply if the State

of the new location of the assets or the grantor has a different conflict-of-laws rule. Therefore, the *Guide* recommends that: (a) for the purpose of determining the law applicable to creation, the relevant location should normally be the location of the encumbered asset or the grantor at the time of putative (purported or asserted) creation (so, in the case of assignments of the same receivables in different locations, both would be effective between the parties); and (b) for the purpose of determining the law applicable to third-party effectiveness and priority, the relevant location should be the location at the time the issue arises (so, the law of the new location of the grantor-assignor would govern third-party effectiveness and priority). However, in a dispute involving only competing claimants whose rights became effective against third parties before a change in location of the asset or the grantor, third-party effectiveness and priority issues should be governed by the law of the initial location (see recommendation 220). The *Guide* also recommends that a secured creditor (the assignee in the case of a receivable) that met the requirements for third-party effectiveness in the first location of the grantor (the assignor in the case of a receivable) should have a short period of time to make its security right effective against parties under the law of the new location of the grantor in order to maintain its third-party effectiveness and priority (so the first grantor-assignor would be protected; see recommendation 45).

11. Public policy and internationally mandatory rules

79. According to the conflict-of-laws rules of many States, the forum State may refuse the application of the law determined under its conflict-of-laws rules only if the effect of its application would be manifestly contrary to the public policy of the forum State or to provisions of the law of the forum State that are mandatory even in international situations. This rule is intended to preserve fundamental principles of justice of the forum State. For example, if, under the law of the forum State, a security right cannot be created in retirement benefits and this is a matter of public policy in the forum State, the forum State may refuse to apply a provision of the applicable law that would recognize the creation of such a right (see recommendation 222). However, this principle should not permit the forum State to apply its own third-party effectiveness and priority rules in the place of those of the applicable law (see recommendation 222, subparagraph (c)). The forum State has to apply other provisions of the applicable law to determine third-party effectiveness and priority. This approach is justified by the need to achieve certainty with respect to the law applicable to third-party effectiveness and priority. The same approach is followed in articles 23, paragraph 2, 30, paragraph 2, and 31 of the United Nations Assignment Convention. It is also followed in article 11, paragraph 3, of The Hague Securities Convention.

12. Impact of commencement of insolvency proceedings on the law applicable to security rights

80. Determining the law applicable to the creation, third-party effectiveness and priority of a security right and the post-default rights of a secured creditor may raise additional issues when insolvency proceedings are commenced in one State and some of the debtor's assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor's business. In either instance, however, most States provide that general conflict-of-laws rules applying outside of insolvency proceedings would govern these matters, subject to

the limitations discussed below. This result is consistent with recommendation 30 of the UNCITRAL Insolvency Guide, which provides that the State in which insolvency proceedings are commenced (that is, the forum State) should apply its conflict-of-laws rules to determine which State's law governs such questions as the validity and effectiveness of rights and claims (including security rights) existing at the time of the commencement of insolvency proceedings (see also recommendation 223 of the *Guide*).

81. Once the validity and effectiveness of a security right are determined under the non-insolvency law applicable outside of insolvency proceedings by virtue of the conflict-of-laws rules of the forum State, a second issue arises concerning the effect of commencement of insolvency proceedings on the priority of security rights. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced (the *lex fori concursus*) governs the commencement, conduct, including the ranking of claims, administration and conclusion of the proceedings (known as the “insolvency effects”) (see recommendation 31 of the UNCITRAL Insolvency Guide). This may have the effect of changing the relative priority that a security right would have under secured transactions law, and also may establish categories of claims that would receive distributions ahead of a security right in insolvency proceedings. In addition, irrespective of priority issues, a security right may be subject to the avoidance provisions of the insolvency law of the forum State (see recommendation 88 of the UNCITRAL Insolvency Guide).

82. While the insolvency effects of insolvency proceedings on security rights typically are governed by the *lex fori concursus*, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable property is located (the *lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The UNCITRAL Insolvency Guide addresses these exceptions in more detail (see part two, chapter I, paras. 85-91), but does not recommend the adoption of a *lex rei sitae* rule for insolvency effects as applied to attachments to immovable property or even to movable property in general. Instead, it generally recommends that any exceptions to the applicability of the *lex fori concursus* for insolvency effects should be limited in number and clearly set forth in the insolvency law (see UNCITRAL Insolvency Guide, part two, chapter I, para. 88, and recommendation 34).

B. Specific remarks concerning multi-unit States

83. The term “State” in this *Guide* refers to a sovereign State. The question arises, however, as to what law applies if, on a given issue, the conflict-of-laws rule refers to a State that comprises more than one territorial unit, with each unit having its own system of law in relation to the issue. This could be the case in federal States in which the secured transactions law generally falls under the legislative authority of their territorial units. For the conflict-of-laws rules to work where the applicable law is the law of such a State (even if the forum State is not a multi-unit State), it is necessary to determine the territorial unit whose law will apply.

84. Normally, references to the law of a multi-unit State are to the law in effect in the relevant territorial unit, as determined on the basis of the applicable connecting factor (such as the location of the asset or the location of the grantor). For instance, if the applicable law is the law of a multi-unit State with three territorial units (A, B and C), a reference to the law of the location of the grantor as the law applicable to a security right in a

receivable means a reference to the law of unit A if the place of central administration of the grantor is in unit A (see recommendation 224).

85. To preserve the consistency of the internal conflict-of-laws rules of a multi-unit State, the *Guide* adopts an approach followed by many international conventions and recommends that such rules continue to apply, but only internally (see recommendation 225). Using the example given in the preceding paragraph, if a grantor is located in unit A of a multi-unit State, the law of unit B would apply where the internal conflict-of-laws rules of unit A point to the law of unit B as the applicable law. This could be the case if the conflict-of-laws rules of unit A envisage (as in the *Guide*) that the law of the grantor's location governs the third-party effectiveness and priority of a security right in a receivable but defines location differently. If the location of the grantor as defined in the *Guide* (that is, the place of central administration) is in unit A but the law of unit A defines the grantor's location as meaning the location of its statutory head office and such office of the grantor is in unit B, then the third-party effectiveness and priority of the security right in the receivable will be governed by the law of unit B. This appears to be a deviation from the general rule on the exclusion of *renvoi* (see recommendation 221). However, this deviation is limited to internal *renvoi*, which does not affect certainty as to the applicable law. In the above example, there would be no reference to a law other than that of unit A should the statutory head office of the grantor be located in a State other than the State of which unit A forms a part.

86. These rules on multi-unit States are relevant only to issues that, in such a State, are governed by the laws of its territorial units. Thus, for example, these rules would have no impact in a federal State whose constitution provides that secured transaction matters are governed by federal laws.

87. In dealing with the law applicable to a security right in a right to payment of funds credited to a bank account, the *Guide* offers alternative recommendations (for the discussion of these alternatives, see paras. 49-51 above). Under alternative A, the applicable law where a bank that maintains the account has places of business in more than one State is the law of the State where the branch maintaining the account is located (see recommendation 210, alternative A). As a consequence, whether the State is a single or multi-unit State will have no impact on determining the applicable law. Under alternative B, however, parties may in certain cases select the law applicable to the account. In the case of a multi-unit State, therefore, references to the "State" in recommendation 210 will refer to the territorial unit and it will be necessary to provide for additional rules to govern the determination of the relevant territorial unit (see recommendations 226 and 227).

C. Recommendations 203-227*

Purpose

The purpose of conflict-of-laws provisions is to determine the law applicable to: the creation, third-party effectiveness and priority of a security right; and the pre- and post-default rights and obligations of the grantor, secured creditor and third parties.²

*The recommendations on conflicts of laws were prepared in close cooperation with the Permanent Bureau of the Hague Conference on Private International Law.

²Conflict-of-laws issues relating to acquisition financing are addressed in chapter IX. Conflict-of-laws issues relating to insolvency are addressed in this chapter and in chapter XII.

1. General recommendations

Law applicable to a security right in a tangible asset

203. The law³ should provide that, except as provided in recommendations 204-207 and 211, the law applicable to the creation, effectiveness against third parties and priority of a security right in a tangible asset is the law of the State in which the asset is located.

204. The law should provide that the law applicable to the issues mentioned in recommendation 203 with respect to a security right in a tangible asset of a type ordinarily used in more than one State is the law of the State in which the grantor is located.

205. The law should provide that, if a security right in a tangible asset is subject to registration in a specialized registry or notation on a title certificate, the law applicable to the issues mentioned in recommendation 203 is the law of the State under whose authority the registry is maintained or the title certificate is issued.

206. The law should provide that the law applicable to the priority of a security right in a tangible asset made effective against third parties by possession of a negotiable document as against a competing security right made effective against third parties by another method is the law of the State in which the document is located.

Law applicable to a security right in a tangible asset in transit or to be exported

207. The law should provide that a security right in a tangible asset (other than a negotiable instrument or a negotiable document) in transit or to be exported from the State in which it is located at the time of the creation of the security right may be created and made effective against third parties under the law of the State of the location of the asset at the time of creation as provided in recommendation 203 or, provided that the asset reaches that State within [a short period of time to be specified] days after the time of creation of the security right, under the law of the State of its ultimate destination.

Law applicable to a security right in an intangible asset

208. The law should provide that the law applicable to the creation, effectiveness against third parties and priority of a security right in an intangible asset is the law of the State in which the grantor is located.

Law applicable to receivables arising from a sale, lease or transaction secured by a security agreement relating to immovable property

209. The law should provide that the law applicable to the creation, effectiveness against third parties and priority of a security right in a receivable arising from a sale, lease or transaction secured by a security agreement relating to immovable property is the law of the State in which the assignor is located. However, the law applicable to a priority conflict involving the right of a competing claimant that is registered in an immovable property registry is the law of the State under whose authority the registry is maintained. The rule in the preceding sentence applies only if registration is relevant under that law to the priority of a security right in the receivable.

³“Law” in this chapter means the secured transactions law or other law in which a State may include conflict-of-laws provisions.

Law applicable to a security right in a right to payment of funds credited to a bank account

210. The law should provide that the law applicable to the creation, effectiveness against third parties, priority and enforcement of a security right in a right to payment of funds credited to a bank account, as well as rights and duties of the depositary bank with respect to the security right, is

*Alternative A**

the law of the State in which the bank that maintains the bank account has its place of business. If the bank has places of business in more than one State, reference should be made to the place where the branch maintaining the account is located.

Alternative B

the law of the State expressly stated in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. However, the law of the State determined pursuant to the preceding sentence applies only if the depositary bank has, at the time of the conclusion of the account agreement, an office in that State that is engaged in the regular activity of maintaining bank accounts. If the applicable law is not determined pursuant to the preceding two sentences, the applicable law is to be determined pursuant to default rules based on article 5 of The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.⁴

This recommendation is subject to the exception provided in recommendation 211.

Law applicable to the third-party effectiveness of a security right in specified types of asset by registration

211. The law should provide that, if the State in which the grantor is located recognizes registration as a method of achieving effectiveness against third parties of a security right in a negotiable instrument or a right to payment of funds credited to a bank account, the law of the State in which the grantor is located is the law applicable to the issue of whether effectiveness against third parties has been achieved by registration under the laws of that State.

Law applicable to a security right in the right to receive the proceeds under an independent undertaking

212. The law should provide that the law of the State specified in an independent undertaking of a guarantor/issuer, confirmer or nominated person is the law applicable to:

(a) The rights and duties of the guarantor/issuer, confirmer or nominated person that has received a request for an acknowledgement or that has or may pay or otherwise give value under an independent undertaking;

(b) The right to enforce a security right in the right to receive the proceeds under the independent undertaking against the guarantor/issuer, confirmer or nominated person; and

(c) Except as provided in recommendation 213, the effectiveness against third parties and priority of a security right in the right to receive the proceeds under the independent undertaking.

213. The law should provide that, if the applicable law is not specified in the independent undertaking of the guarantor/issuer or confirmer, the law applicable to the issues referred to in recommendation 212 is the law of the State of the location of the branch or office of the

*A State may adopt alternative A or alternative B of recommendation 210.

⁴A State that adopts alternative B of recommendation 210 has to adopt also recommendations 226 and 227.

guarantor/issuer or confirmer indicated in the independent undertaking. However, in the case of a nominated person, the applicable law is the law of the State of the location of the nominated person's branch or office that pays or otherwise gives value under the independent undertaking.

214. The law should provide that the law applicable to the creation and effectiveness against third parties of a security right in a receivable, negotiable instrument or other claim, the payment or other performance of which is secured by an independent undertaking, is also the law applicable to the issue of whether a security right in the right to receive the proceeds under the independent undertaking is created and made effective against third parties automatically as contemplated in recommendations 25 (chapter II on the creation of a security right) and 48 (chapter III on the effectiveness of a security right against third parties).

Law applicable to a security right in proceeds

215. The law should provide that:

(a) The law applicable to the creation of a security right in proceeds is the law applicable to the creation of the security right in the original encumbered asset from which the proceeds arose; and

(b) The law applicable to the effectiveness against third parties and priority of a security right in proceeds is the law applicable to the third-party effectiveness and priority of a security right in an asset of the same kind as the proceeds.

Law applicable to the rights and obligations of the grantor and the secured creditor

216. The law should provide that the law applicable to the mutual rights and obligations of the grantor and the secured creditor arising from their security agreement is the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement.

Law applicable to the rights and obligations of third-party obligors and secured creditors

217. The law should provide that the law applicable to a receivable, negotiable instrument or negotiable document also is the law applicable to:

(a) The relationship between the debtor of the receivable and the assignee of the receivable, and the relationship between an obligor under a negotiable instrument and the holder of a security right in the instrument;

(b) The conditions under which an assignment of the receivable, a security right in the negotiable instrument or a security right in the negotiable document may be invoked against the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document (including whether an anti-assignment agreement may be asserted by the debtor of the receivable, the obligor or the issuer); and

(c) Whether the obligations of the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document have been discharged.

Law applicable to enforcement of a security right

218. The law should provide that, subject to recommendation 223, the law applicable to issues relating to the enforcement of a security right:

(a) In a tangible asset is the law of the State where enforcement takes place; and

(b) In an intangible asset is the law applicable to the priority of the security right.

Meaning of “location” of the grantor

219. The law should provide that, for the purposes of the conflict-of-laws provisions, the grantor is located in the State in which it has its place of business. If the grantor has a place of business in more than one State, the grantor’s place of business is that place where the central administration of the grantor is exercised. If the grantor does not have a place of business, reference is to be made to the habitual residence of the grantor.

Relevant time for determining location

220. The law should provide that:

(a) Except as provided in subparagraph (b) of this recommendation, references to the location of the assets or of the grantor in the conflict-of-laws provisions refer, for creation issues, to the location at the time of the putative creation of the security right and, for third-party effectiveness and priority issues, to the location at the time the issue arises;

(b) If the rights of all competing claimants in an encumbered asset were created and made effective against third parties before a change in location of the asset or the grantor, references in the conflict-of-laws provisions to the location of the asset or of the grantor refer, with respect to third-party effectiveness and priority issues, to the location prior to the change in location.

Exclusion of renvoi

221. The law should provide that a reference in the conflict-of-laws provisions to “the law” of another State as the law applicable to an issue refers to the law in force in that State other than its conflict-of-laws provisions.

Public policy and internationally mandatory rules

222. The law should provide that:

(a) The application of the law determined under the conflict-of-laws provisions may be refused only if the effects of its application would be manifestly contrary to the public policy of the forum;

(b) The conflict-of-laws provisions do not prevent the application of those provisions of the law of the forum which, irrespective of conflict-of-laws provisions, must be applied even to international situations; and

(c) Subparagraphs (a) and (b) of this recommendation do not permit the application of the provisions of the law of the forum to the third-party effectiveness and priority of a security right.

Impact of commencement of insolvency proceedings on the law applicable to a security right

223. The law should provide that the commencement of insolvency proceedings does not displace the conflict-of-laws provisions that determine the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right (and, in the context of the non-unitary approach, a retention-of-title right and financial lease right). However, this provision should be subject to the effects on such issues of the application of the insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) to issues such as avoidance, treatment of secured creditors, ranking of claims or distribution of proceeds.⁵

⁵See recommendation 31 of the UNCITRAL Insolvency Guide.

2. Special recommendations when the applicable law is the law of a multi-unit State

224. The law should provide that, in situations in which the law applicable to an issue is the law of a multi-unit State subject to recommendation 225, references to the law of a multi-unit State are to the law of the relevant territorial unit (as determined on the basis of the location of the grantor or of an encumbered asset or otherwise under the conflict-of-laws provisions) and, to the extent applicable in that unit, to the law of the multi-unit State itself.

225. The law should provide that if, under its conflict-of laws provisions, the applicable law is that of a multi-unit State or one of its territorial units, the internal conflict-of laws provisions in force in the multi-unit State or territorial unit determine whether the substantive provisions of law of the multi-unit State or of a particular territorial unit of the multi-unit State apply.

226. The law should provide that, if the account holder and the depositary bank have chosen the law of a specified territorial unit of a multi-unit State as the law applicable to the account agreement:

(a) The references to “State” in the first sentence of recommendation 210 (alternative B) are to the territorial unit;

(b) The references to “that State” in the second sentence of recommendation 210 (alternative B) are to the multi-unit State itself.

227. The law should provide that the law of a territorial unit is the applicable law if:

(a) Under recommendations 210 (alternative B) and 226, the designated law is that of a territorial unit of a multi-unit State;

(b) Under the law of that State, the law of a territorial unit is the law applicable only if the depositary bank has an office within that territorial unit which satisfies the condition specified in the second sentence of recommendation 210 (alternative B); and

(c) The provision described in subparagraph (b) of this recommendation is in force at the time the security right in the bank account is created.⁶

⁶Only a State that adopts alternative B of recommendation 210 needs to adopt recommendations 226 and 227.

XI. Transition

A. General remarks

1. Introduction

1. The previous chapter addressed “conflict of laws”, that is, the set of rules to determine, in cases where two or more legal systems have substantive rules that might apply to a particular transaction, which substantive rules will in fact apply. Often these conflict-of-laws rules are described as rules governing conflict of laws “in space”, in order to distinguish them from a different type of conflict-of-laws rules, namely, those governing conflict of laws “in time”. All legislative action raises issues relating to conflict of laws in time. Hence, most States have well-developed principles to determine, for example, when a new law comes into force, its impact on rights acquired under prior law and the extent of its application to existing legal relationships. Where a major reform to existing law is contemplated, however, States usually incorporate into the new law a set of specific rules governing conflict of laws in time as they arise in connection with the coming into force of the new law. These rules are typically known as “transition provisions”. In view of the scope of preceding chapters, the *Guide* recommends that States adopt such a series of transition provisions tailored specifically to the new law they enact.

2. The new secured transactions law reflecting the recommendations of the *Guide* is likely to depart in significant ways from the prior secured transactions law. Those differences will have an obvious impact on any agreements that grantors and secured creditors enter into after the new law is enacted. However, many transactions entered into under the prior law will be ongoing when the new law comes into force. In the light of the differences between the prior and new legal regimes and the continued existence of transactions and security rights created under the prior law, it is important for the success of the new law that it contains fair and efficient rules governing the transition from the prior law to the new law. A similar need for transition rules is present when, under the conflict-of-laws rules of the prior law, the law of a different State (that is, different from the State whose law governs that issue under the conflict-of-laws rules of the new law) governed the creation, third-party effectiveness or priority of a security right. Thus, for example, the conflict-of-laws rules of the prior law might point to the law of the location of the debtor of an obligation for questions of third-party effectiveness, while the conflict-of-laws rules of the new law might point to the law of the location of the grantor of the security right.

3. Two basic issues related to the transition from the prior law to the new law must be addressed. First, as discussed in section A.2, the new law should provide the date as of which it (or dates as of which its various parts) will come into force (the “effective date”). Second, as discussed in section A.3, the new law should also specify the extent to which, after the effective date, the new law applies to transactions or security rights that existed before the effective date. The particular principles to govern various transitional situations are set out in section A.4. The chapter concludes, in section B, with a series of recommendations.

2. *Effective date of the new law*

4. A number of factors must be considered in determining the effective date of the new law. Prompt realization of the economic advantages of the new law is a reason for States to bring the new law into force as soon as possible after enactment. These advantages must be balanced, however, against the need to avoid causing instability in, or disruption of, the markets that will be governed by the new law. Market participants must be given adequate time to prepare for conducting transactions under the new law, which may be significantly different in both form and substance from transactions under the prior law. Accordingly, and depending on the extent to which the new law had been the subject of public discussion, a State may conclude that the new law should not come into force immediately upon its enactment. That is, in order for these markets and their participants to adjust their conduct in preparation for the new rules, and to ensure that appropriate educational programmes for judges, arbitrators, lawyers and business people can be prepared and presented, States may set the effective date of the new law at some reasonable period of time after its enactment.

5. When choosing an effective date, States may consider various factors, including the following: (a) the impact of the effective date on credit decisions; (b) maximization of benefits to be derived from the new law; (c) the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; (d) the status of the pre-existing law and other infrastructure; (e) the harmonization of the new secured transactions law with other law; (f) constitutional limits, if any, to the retroactive effect of the new law; and (g) standard or convenient practice for the entry into force of the new law (such as on the first day of a month).

6. States generally adopt one of three methods for bringing law into force at a date subsequent to enactment. First, sometimes, the general law or the enacting law simply provides that the new law will come into force on a future date fixed by a “decree” or a “proclamation”. Second, in other cases, the law itself will specify that future date. For example, if a law were enacted on 17 January of a given year that law might expressly provide that it comes into force on 1 September of the same year. Third, frequently, the law will contain a specific formula for determining its effective date. There are many examples of how formulas could be used. One example of a formula would be that the effective date would be the first day of the calendar month following the expiration of six months after the date of enactment. Another formula could be one that refers to the first day of January or July, whichever occurs first, following the expiration of six months after the date of enactment. Still another type of formula is often used where it is necessary to delay the effective date in order to allow time to build a technical infrastructure, such as a computerized registry. In these cases, States typically use a “decree” to the effect that, for example, the date the registry becomes operational will be the starting point for the six-month delay. The *Guide* does not take a position on which of these methods a State should use, since they are inevitably a matter of national practice. It does recommend nonetheless that States either specify the effective date, whether in the law or in an accompanying proclamation, or set out a formula for determining the effective date in the secured transactions law itself (see recommendation 228).

3. General approach to acquired rights

7. As secured obligations are often payable over a period of time, it is likely that there will be many rights created before the effective date that will continue to exist after the effective date, securing debts that are not yet fully paid. Therefore, States also must consider whether the new law should apply to issues that arise after the effective date when those issues relate to transactions entered into prior to the effective date.

8. One approach would be for the new law to apply prospectively only. It would, therefore, not govern any aspects of transactions entered into prior to the effective date. While this approach has a certain appeal, especially with respect to issues that arise between the grantor and the secured creditor, it would create significant problems when the rights of third parties are involved, especially with respect to priority issues. Foremost among those problems would be the need to resolve priority disputes between a secured creditor that obtained its security right prior to the effective date and a competing secured creditor that obtained its security right in the same encumbered assets after the effective date. Because priority is a comparative concept, the same priority rule must govern the two security rights that are being compared. It is, consequently, not feasible for the prior rules to govern the priority of the security right of the pre-effective-date secured creditor and the new rules to govern the priority of the security right of the post-effective-date secured creditor.

9. Determining which priority rule should apply to priority disputes between pre- and post-effective-date security rights is not without difficulty. Applying the prior rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new law, with the result that the significant economic benefits it brings could be deferred for a substantial period of time. The delay would affect all new transactions even though it would be needed for only some of the old transactions. Moreover, the delay would prevent parties with security agreements that cover future assets from taking advantage of the new law for assets acquired or produced after the new law's effective date. However, applying the new rules to such priority disputes might unfairly prejudice parties that relied on the prior law. This would especially be the case for those parties that relied on the prior law without notice that the law might be changed. In addition, applying the priority rules retroactively might provide an incentive for parties to existing security agreements to object to the new law or advocate an unduly delayed effective date.

10. Alternatively, greater certainty and earlier realization of the benefits of the new law could be promoted by applying the new law to all transactions as of the effective date, but with appropriate transition provisions to govern the status of pre-effective-date security rights. These transition provisions would provide for the integration of such security rights into the new law without loss of the priority status they had at the effective date of the new law. Such an approach would avoid the problems of either of the all-or-nothing options identified in the previous paragraph. By offering a mechanism to protect acquired priority, it would fairly and efficiently balance the interests of parties that complied with the prior law with the interests of parties that comply with the new law.

11. It is not just questions of priority that will interest persons with pre-effective-date security rights. Litigation may be under way at the time the law comes into force. These proceedings might relate to post-default enforcement, or even to a pre-default dispute

between the grantor and a secured creditor, or between a competing claimant and the grantor. In keeping with the general logic of protecting acquired rights, a secured creditor, the grantor, or a competing claimant that has initiated but not concluded legal proceedings before the effective date of the new law should be given an option as to how to pursue the resolution of the dispute. The initiator of the proceedings should be permitted either to continue the proceedings under the prior law or to abandon them and initiate proceedings under the new law.

12. Taking into account these considerations, the *Guide* recommends that States adopt the following general approach: (a) the new law should be immediately applicable to all transactions entered into after its effective date; (b) there should be no general retroactive application of the new law to transactions entered into prior to its effective date; (c) the new law should apply to issues and procedures (for example, priority disputes and enforcement mechanisms) arising after its effective date, even in relation to agreements entered into under the prior law; and (d) the new law should contain detailed transition provisions to protect the rights that parties acquired under transactions entered into prior to the effective date (see recommendation 228, second sentence).

4. *Issues to be addressed by transition provisions*

(a) *General*

13. Many security rights created before the effective date of the new law will continue to exist after the effective date and may come into conflict with security rights created under the new law. Clear transition provisions are thus needed to determine the extent to which the rules in the new law will apply to those pre-existing security rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction that created a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between a holder of a security right and a competing claimant, when either the security right or the right of the competing claimant was created before the effective date.

14. No single rule or formula to govern all cases is possible because, even if all States were to implement the *Guide* in an identical fashion, each State would be transitioning from a different pre-existing regime. Further, the particularities of the pre-existing regime will have an effect on the decisions made with respect to transition. For example, States will need to take into account how easy it will be to determine that assets were subject to a security right under the prior regime, how long existing transactions should go on “untouched” by the new law and, in cases where under the prior law it was necessary for a secured creditor to renew a registration or take other action to maintain third-party effectiveness, how and by what date that renewal should be made under the new law. The discussion that follows reviews the principal issues that States must address in developing these transition provisions.

(b) Disputes before a court or arbitral tribunal

15. When a dispute is in litigation at the effective date, the rights of the parties have sufficiently crystallized so that the coming into force of a new legal regime should not change the outcome of that dispute. The same principle should apply when the dispute is taken before a comparable dispute resolution system, such as arbitration, that provides a binding determination of rights. In contrast, the principle should not apply when the parties have recourse to a non-binding process, such as conciliation (also called mediation). The non-binding character of the proceedings indicates that the rights of the parties have not sufficiently crystallized. It follows, therefore, that such an ongoing dispute should not be resolved by application of the new legal regime (see recommendation 229, first sentence). Moreover, within the context of ongoing enforcement proceedings, parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law that specifically address the questions being litigated. All aspects of enforcement should, in principle, continue under the prior law (see recommendation 229, second sentence).

16. Litigation may, of course, involve matters other than enforcement. Pre-default disputes may arise between the grantor and the secured creditor, or between a competing claimant, such as a purchaser of the encumbered asset, and the secured creditor. In these cases, ongoing litigation on one aspect of a secured transaction should not preclude the application of the new law to aspects of the transaction that are not the subject of litigation. Nor should it prevent parties from commencing litigation on any such matters under the new law. Thus, for example, the grantor may be in litigation concerning the right of the secured creditor to use an encumbered asset in the possession of the secured creditor. This continuing litigation under the prior law should not preclude the secured creditor from commencing an enforcement action under the new law, once the effective date has occurred. Finally, as already mentioned (see para. 11 above), should any proceedings be ongoing under the prior law, the initiator of those proceedings should be permitted either to continue the proceedings under the prior law or to abandon them and initiate proceedings under the new law.

(c) Effectiveness of pre-effective-date rights as between the parties

17. When a security right has been created before the effective date of the new law, two questions arise regarding the effectiveness of that right between the grantor and the creditor. The first question is whether a security right that was effectively created under the prior law but does not fulfil the requirements for creation under the new law will become ineffective on the effective date of the new law. The second question is whether a security right that was not effectively created under the prior law but fulfils all the requirements for creation of a security right under the new law will become effective on the effective date of the new law.

18. With respect to the first question, different approaches are possible. For example, a transition period might be established during which the security right would remain effective between the parties, so that the creditor could take the necessary steps for its creation under the new law during the transition period. At the expiration of the transition period, if such steps had not been taken the right would become ineffective under the new law. A

simpler approach, however, and the approach recommended in the *Guide*, is to provide that, if a security right was created and is made effective between the parties before the effective date of the new law, it remains effective between them after the new law comes into force (see recommendation 230).

19. With respect to the second question, consideration should be given to making the previously ineffective right effective as of the effective date of the new law, since the parties presumably intended the right to be effective as between them when they entered into their agreement. Nonetheless, some States address this issue by requiring a specific confirmation by the grantor that it intends the previously ineffective right to be effective under the new law. Such a requirement is difficult to put into practice, however, since it presumes, implausibly, that at least one of the parties knew of the defect, failed to do anything to correct it under the prior law, but now wishes the security right to be effective. The more likely case involves the discovery of the defect after the new law came into force, in which case a rule providing for automatic effectiveness upon the coming into force of the new law is justified. This is the approach recommended in the *Guide* (see recommendation 228, second sentence).

(d) Effectiveness of pre-effective-date rights against third parties

20. Different issues arise as to the effectiveness against third parties of a right created before the effective date of the new law. As the new law will embody public policy regarding the proper steps necessary to make a security right effective against third parties, it is preferable for the new rules to apply to the greatest extent possible. It may, however, be unreasonable to expect a creditor whose right was effective against third parties under the previous legal regime of the enacting State (or under the law of the State whose law applied to third-party effectiveness under the conflict-of-laws rules of the prior regime) to comply immediately with any additional requirements of the new law. The expectation would be especially onerous for institutional creditors that would be required to comply with the additional requirements of the new law simultaneously for large numbers of pre-effective-date transactions.

21. A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules to remain effective for a reasonable period of time (as specified in the transition provisions in the new law) so as to give the creditor time to satisfy the requirements of the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law. This is the approach recommended in the *Guide* (see recommendation 231). In determining the length of time within which creditors are permitted to make their existing rights effective against third parties, States should consider a number of practical questions. For example, where a registry system for security rights already exists, a longer period might be contemplated. As long as the old registry remains operational, third parties would continue to have a means to determine if a security right encumbers particular assets. By contrast, where no registry system for security rights is in place, a shorter period might be considered, at least for rights for which a notice was not required to be registered under the prior law. Absent registration or notice, third parties would not have an easy means to determine whether a pre-existing security right encumbers a potential grantor's assets.

22. If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new law, the right should be effective against third parties immediately upon the effective date of the new law. As already mentioned (see para. 19 above), it can be presumed that the parties had intended the security right to be effective between them under the prior law, even if it was not. Since a security right can only be effective against third parties if it is first created and effective between the parties, should the security right that was previously ineffective against third parties become effective against them under the new law, the third parties are protected to the full extent provided for in the new law. This is the approach recommended in the *Guide* (see recommendation 228, second sentence).

(e) *Priority disputes*

23. An entirely different set of questions arises in the case of priority disputes, because such disputes necessarily involve applying one set of rules to two (or more) different rights created at different times under different regimes. A legal system cannot simply provide that the priority rule in effect at the time when a security right was created governs priority with respect to that right because such a rule would not provide a coherent answer when one of the rights that is being compared was created under the prior law while the other was created under the new law. Rather, there must be rules that address each of the following situations: (a) where both rights are created and made effective against third parties after the effective date of the new law; (b) where both rights are created and made effective against third parties before the effective date; and (c) where one right is created and made effective against third parties before the effective date and the other right is created and made effective against third parties after the effective date.

24. The easiest situation is a priority dispute between competing claimants whose rights were created and made effective against third parties after the effective date of the new law. In that situation, it is obvious that the priority rules in the new law should be applied to resolve that dispute. This is the approach recommended in the *Guide* (see recommendation 232).

25. If, by contrast, both of the competing rights were created and made effective against third parties before the effective date of the new law, further inquiries are needed. It is important not just that the relative priority of the two competing rights in the encumbered assets was established before the effective date of the new law; it is also important that, in addition, nothing other than the effective date having occurred has happened that would change that relative priority. In such a case, stability of relationships suggests that the priority established before the effective date should not be changed merely because the new law came into force. If, however, something occurs after the effective date that would have had an effect on priority under the previous legal regime (such as a security right becoming effective against third parties or ceasing to be effective against third parties), there is less reason to continue to utilize the former law to govern a dispute that has been changed by an action or event that took place after the effective date. There is a much stronger argument for applying the new law to such a situation. In other words, the existing rights of parties as they stood when the new law came into force are protected, but parties should not be relieved of the obligation to make certain that they avoid acting, or failing to act, in such a way that their existing rights are no longer preserved under the new law. This is the approach recommended in the *Guide* (see recommendations 232-234).

26. The most difficult transition situation involves a priority dispute between one right that was created and made effective against third parties before the effective date and another right that was created and made effective against third parties after the effective date. In such a case, while it is preferable to have the new rules govern eventually (indeed, sooner rather than later), it is appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the prior regime. Provided that creditor takes whatever steps are necessary to maintain protection under the new regime within the time prescribed in the transition rule, the new law should provide that creditor with the same priority that it would have enjoyed had the new rules been effective at the time of the original transaction and those steps had been taken in a timely fashion under the prior law. This is the approach recommended in the *Guide* (see recommendation 232). Here is an example to illustrate this idea. A secured creditor acquired a security right effective against third parties without registration under the prior law, and the new law provides that the right has to be registered within 60 days following the effective date of the new law in order to remain effective against third parties. Should that secured creditor register 50 days after the effective date, it would have priority over a secured creditor that acquired a security right after the effective date and made it effective against third parties by registering 30 days after the effective date. That is, the first creditor would maintain its priority status, because its right never ceased to be effective against third parties and it had acquired its first priority under the prior law.

(f) *Enforcement*

27. Disputes may be in litigation or in an alternative dispute resolution system, such as arbitration, at the date when the new law comes into force. As already noted (see paras. 15 and 16 above), in these cases, the rights of the parties have sufficiently crystallized so that the coming into force of a new legal regime should not change the outcome of that dispute. This is the approach recommended in the *Guide* (see recommendation 229). Moreover, parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law. For example, if non-judicial enforcement is prohibited under the prior law, but authorized under the new law, enforcing parties should not be able to convert an ongoing judicial enforcement process into a non-judicial enforcement process. Likewise, within the context of ongoing enforcement proceedings, parties should not normally be permitted to invoke defences or other rights contained only in the new law. The scope of the principle is, however, open to interpretation. In one view, once a creditor has commenced enforcement under the prior law, it should be deemed to have opted for enforcement under that law, and cannot thereafter attempt to avail itself of recourses available under the new law. In another view, the principle means only that the creditor cannot be forced to convert proceedings commenced under the prior law into proceedings under the new law. It may continue to proceed with enforcement as if the new law had not yet come into force. If, however, the enforcing creditor were to abandon ongoing judicial or arbitral enforcement proceedings, in this view, nothing would prevent that creditor from commencing other enforcement proceedings (including non-judicial enforcement proceedings) under the new law. For reasons already mentioned (see para. 11 above), the *Guide* recommends that the secured creditor may continue enforcement under the prior law (see recommendation 229, second sentence) or may abandon such enforcement and commence enforcement under the new law.

28. Nonetheless, the vast bulk of disputes that involve transactions entered into before the coming into force of the new law will arise after the new law becomes effective. Two different situations can arise. On the one hand, it may be that secured creditors are entitled to exercise certain remedies and grantors are permitted to plead certain defences that are no longer permitted under the new law. On the other hand, it may be that the new law permits creditors to avail themselves of new remedies and permits debtors to plead new defences not previously permitted. The following two examples illustrate the issue.

29. Where the new law abolishes certain remedies, or makes them subject to a new and more onerous procedure, there is an argument that creditors should not be prejudiced by the new law. For example, in some States, creditors in possession may, upon default, simply keep a pledged asset without having to give notice to the grantor or third parties. The *Guide*, by contrast, contemplates that a creditor would have to give notice of its intention to accept the asset in satisfaction of the secured obligation (see recommendations 156-159).

30. A similar rationale applies to cases where grantors are deprived of defences or procedural rights that could be exercised under the prior law. For example, in some States, grantors in default may suspend enforcement proceedings by remedying the particular omission that led to the default, thereby reinstating the secured obligation and stopping enforcement. The *Guide*, by contrast, envisages that grantors have a right to redeem the security by paying the outstanding obligation, but have no right to cure the default and reinstate the obligation (see recommendation 140).

31. In both these cases, there is an argument that the prejudice potentially suffered by a secured creditor or a grantor with the coming into force of the new law is sufficient to justify not abolishing any rights arising under the prior law, even in respect of enforcement that commences after the effective date of the new law. Both should be entitled to enforce the original agreement according to the law applicable when the agreement was entered into. By contrast, there is an equally strong argument that, because the new enforcement regime results from a State carefully considering how best to balance the rights of all parties, it should apply to all post-effective-date enforcement remedies. This argument is particularly persuasive when enforcement will affect the rights of third parties that have taken security rights in the assets after the effective date of the new law. Moreover, because the relative balance to be struck depends on the particular configuration of secured creditors' enforcement rights and grantors' defences in individual States under the prior law, the *Guide* recommends the general principle of immediate application (see recommendation 228).

32. This said, other law in a State (for example, the general law of obligations or constitutional principles relating to retroactive interference with property rights) may affect the precise extent to which enforcement proceedings commenced after the new law comes into force are affected by the principle of immediate application.

33. As for the opposite case, where the new law provides secured creditors with new remedies or grantors with new procedural rights, the argument for applying the new law to transactions existing prior to its coming into force is compelling. A secured creditor under the prior law that has taken the steps necessary to ensure third-party effectiveness under the new law should be in no different a position than a creditor that initially obtains a security right under the new law. Similarly, any new defences or procedural rights given

to grantors and third parties under the new law should be available in connection with enforcement proceedings undertaken by all secured creditors, including those creditors enforcing rights arising under transactions that existed before the new law came into force. That is, the new enforcement regime presumably reflects a State's best judgement as to a fair and efficient regime for enforcing security rights. Thus, if the new law is appropriate for security rights that have been created and made effective against third parties after the effective date of the new law, it should also apply to the post-effective-date enforcement of security rights created and made effective against third parties before the effective date of the new law. This is the approach recommended in the *Guide* (see recommendation 228, second sentence).

B. Recommendations 228-234

Purpose

The purpose of provisions on transition is to provide a fair and efficient transition to the law from the regime in force before the effective date of the law.

Effective date

228. The law should specify either a date subsequent to its enactment on which it comes into force (the "effective date") or a mechanism by which the effective date may be determined. From its effective date, the law applies to all transactions within its scope, whether entered into before or after that date, except as provided in recommendations 229-234.

Inapplicability of the law to actions commenced before the effective date

229. The law should provide that it does not apply to a matter that is the subject of litigation or alternative binding dispute resolution proceedings that were commenced before the effective date. If enforcement of a security right has commenced before the effective date, the enforcement may continue under the law in force before the effective date ("prior law").

Creation of a security right

230. The law should provide that prior law determines whether a security right was created before the effective date.

Third-party effectiveness of a security right

231. The law should provide that a security right that is effective against third parties under prior law remains effective against third parties until the earlier of:

- (a) The time it would cease to be effective against third parties under prior law; and
- (b) The expiration of a period of [a period of time to be specified] months after the effective date ("the transition period").

If the requirements for third-party effectiveness under this law are satisfied before third-party effectiveness would have ceased under the preceding sentence, third-party effectiveness is continuous.

Priority of a security right

232. Subject to recommendations 233 and 234, the law should provide that it governs the priority of a security right. The time when a security right referred to in recommendation 231 was made effective against third parties or became the subject of a registered notice under prior law is the time to be used in determining the priority of that right.

233. The law should provide that the priority of a security right is determined by prior law if:

(a) The security right and the rights of all competing claimants arose before the effective date; and

(b) The priority status of none of these rights has changed since the effective date.

234. The law should provide that the priority status of a security right has changed if:

(a) It was effective against third parties on the effective date as provided in recommendation 231 and later ceased to be effective against third parties; or

(b) It was not effective against third parties on the effective date and later became effective against third parties.

XII. The impact of insolvency on a security right

A. General remarks

1. Introduction

1. The preceding chapters of the *Guide* provide commentary and recommendations aimed at assisting States in the development of effective and efficient secured transactions laws. The goal has been to set out a framework for regulating the rights of grantors, secured creditors and third parties whenever grantors seek to encumber assets with a security right. The *Guide* generally does not address issues related to the basic law of obligations and property, nor does it directly address matters of civil procedure and the regime governing the enforcement of judgements. The *Guide* leaves these matters to other law. However, there is one field of law, insolvency law, where as a practical matter the regime of secured transactions deeply interacts with other law and thus needs to be directly addressed in the *Guide*.

2. Secured transactions laws and insolvency laws have different concerns and objectives, some of which may overlap where the rights regulated by a secured transactions law are affected by the commencement of insolvency proceedings. A secured transactions law seeks to promote secured credit, because security for an obligation reduces the risk of non-payment of the obligation (“default”). It allows debtors to use the full value of their assets to obtain credit and develop their enterprises. In the case of default by a debtor, a secured transactions law seeks to ensure that the value of the encumbered assets protects the secured creditor. It focuses on effective enforcement of the rights of individual creditors to maximize the likelihood that, if the secured obligations owed are not performed, the economic value of the encumbered assets can be realized to satisfy the secured obligations.

3. An insolvency law, on the other hand, is principally concerned with collective business and economic issues. It seeks, among other objectives, to preserve and maximize the value of the debtor’s assets for the collective benefit of creditors and to facilitate equitable distribution to creditors. The achievement of these objectives will be assisted by preventing a race among creditors to enforce individually their rights against a common debtor, and by facilitating the reorganization of viable business enterprises and the liquidation of businesses that are not viable. For these reasons, an insolvency law may affect the rights of a secured creditor in different ways once insolvency proceedings commence.

4. Since reform of one law can impose unforeseen transaction and compliance costs on parties under the other law and create tension between the two laws, legislators revising existing laws or introducing a new law in the field of either insolvency or secured transactions will need to ensure that any new or revised law properly takes account of an existing or proposed law in the other field. In some cases, review of the law in one field may point to the need to revise or develop a new law in the other field. In any event, to the extent that an insolvency law affects the rights of secured creditors, those effects should

be based on carefully articulated policies and stated clearly in the insolvency law, as recommended throughout the UNCITRAL Insolvency Guide, adopted by UNCITRAL on 25 June 2004.¹

5. The effects of insolvency proceedings on security rights are discussed in detail, as a matter of insolvency law, in the UNCITRAL Insolvency Guide. The purpose of the present chapter is to highlight some of the key points of intersection between an insolvency law and a secured transactions law. The chapter discusses, in section A.3, the general principles concerning security rights in insolvency. Section A.4 reviews the law applicable in insolvency proceedings, while section A.5 elaborates upon the treatment of encumbered assets. Section A.6 considers post-commencement finance; section A.7, the treatment of contracts; and section A.8, avoidance proceedings. The next three sections deal with the participation of secured creditors in insolvency proceedings (section A.9), reorganization proceedings (section A.10) and expedited reorganization proceedings (section A.11). The last four sections address the treatment of secured claims (section A.12), the ranking of secured claims (section A.13), acquisition financing (section A.14) and receivables subject to an outright transfer before commencement of insolvency proceedings (section A.15).

6. To provide a sufficient discussion of the effects of insolvency proceedings on security rights in this *Guide*, core recommendations from the UNCITRAL Insolvency Guide that relate particularly to security rights are included in this chapter. For a more complete discussion, however, this chapter should be read together with both the commentary and the recommendations of the UNCITRAL Insolvency Guide. This chapter also includes discussion of some additional recommendations elaborating on issues discussed in the UNCITRAL Insolvency Guide but not the subject of recommendations in that Guide. The recommendations from the UNCITRAL Insolvency Guide and the additional recommendations are set out in section B of this chapter.

2. Terminology

7. The UNCITRAL Insolvency Guide and this *Guide* use a number of terms (see UNCITRAL Insolvency Guide, Introduction, section B, Glossary, and this *Guide*, Introduction, section B, Terminology and interpretation). In addition to the terms just referred to, this chapter also includes certain terms from the UNCITRAL Insolvency Guide that facilitate understanding of the recommendations of that Guide.

8. Certain terms that are explained in the UNCITRAL Insolvency Guide are not explained again in this *Guide* and thus have the same meaning as in the UNCITRAL Insolvency Guide.² Other terms, however, have been either slightly reworded or are explained differently in this *Guide* and therefore have a different meaning in this chapter, as indicated below.

¹For the decision of the United Nations Commission on International Trade Law and the resolution of the General Assembly (resolution 59/40 of 2 December 2004), see the UNCITRAL Insolvency Guide, annex II. The UNCITRAL Insolvency Guide, which includes in its annex III the UNCITRAL Model Law on Cross-Border Insolvency and its Guide to Enactment, can be found at www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html.

²The term “financial contract”, for instance, is used in this *Guide* in the same way as in the UNCITRAL Insolvency Guide in accordance with article 5, subparagraph (k), of the United Nations Assignment Convention. The note that follows that term in this *Guide* merely explains it.

9. The term “security right” is explained in this *Guide*. As used in this chapter, it is not a synonym for “security interest” as defined in the UNCITRAL Insolvency Guide. The term “security interest” is broader in that it refers generally to a right in an asset to secure payment or other performance of one or more obligations and, accordingly, potentially covers security rights in immovable property (which are outside the scope of this *Guide*; see recommendation 5) and non-consensual security rights (which are not covered by the term “security right” in this *Guide*, Introduction, section B, Terminology and interpretation).

10. Similarly, the term “priority” is used in this chapter as explained in this *Guide* and not as explained in the UNCITRAL Insolvency Guide. The meaning of the term “priority” in the UNCITRAL Insolvency Guide is narrower, referring only to the priority of claims in the context of insolvency (“the right of a claim to rank ahead of another claim where that right arises by operation of law”; see terminology below under section B.1). This *Guide* uses the term “priority” to refer to “the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant” (see Introduction, section B, Terminology and interpretation). To refer to “priority” in insolvency proceedings, this chapter uses the term “ranking of claims” (see, for example, paras. 59-63 below).

11. The term “debtor” as used in this *Guide* refers to the person owing the secured obligation (see Introduction, section B, Terminology and interpretation). As that term would not work well in the present chapter, “debtor” in this chapter has the meaning given to the term in the UNCITRAL Insolvency Guide, that is, a person that meets the requirements for the commencement of insolvency proceedings (see UNCITRAL Insolvency Guide, part two, chapter I, paras. 1-11, and recommendation 8).

12. In addition, as other chapters of this *Guide* focus on the term “grantor” (that is, the person that creates a security right; see Introduction, section B, Terminology and interpretation) rather than the term “debtor” (that is, the person owing the secured obligation), references in this chapter to “debtor” should be understood as referring to situations where the grantor is the debtor in the insolvency proceedings.

3. *General principles concerning security rights in insolvency*

13. The UNCITRAL Insolvency Guide recognizes in principle the creation, third-party effectiveness, enforceability (see recommendation 4 of the UNCITRAL Insolvency Guide) and priority (see recommendation 1 of the UNCITRAL Insolvency Guide) of a security right as established under law other than insolvency law (see recommendations 238 and 239 of this *Guide*). However, to achieve the goals of insolvency proceedings, the rights that a secured creditor has outside of insolvency proceedings may need to be modified or affected once the insolvency proceedings commence. In such a case, it is desirable that an insolvency law also include appropriate protections for the secured creditor. As noted throughout the UNCITRAL Insolvency Guide, what is important for the availability of secured credit is that insolvency law contain clear rules as to the effect of insolvency proceedings on the rights of a secured creditor, so as to enable secured creditors to quantify the risks associated with insolvency and incorporate those risks into their assessment of whether to extend credit and on what terms.

4. *Applicable law in insolvency proceedings*

14. The determination of the law applicable to the creation, third-party effectiveness and priority of a security right and the post-default rights of a secured creditor may be a complex issue when insolvency proceedings are commenced in one State and some of the debtor's assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor's business. In either instance, general conflict of laws rules applying outside of insolvency proceedings would govern these matters, subject to the limitations discussed in sections 4 (a) and 4 (b) below and the application of avoidance provisions of the insolvency law (see recommendation 223 of this *Guide*). This result is made clear in recommendation 30 of the UNCITRAL Insolvency Guide, which provides that the State in which insolvency proceedings are commenced (that is, the forum State) should apply its conflict-of-laws rules to determine which State's law governs such questions as the creation and third-party effectiveness of a security right existing at the time of the commencement of insolvency proceedings.

(a) *Insolvency effects: lex fori concursus*

15. Once the creation and third-party effectiveness of a security right are determined under the non-insolvency law applicable outside of insolvency proceedings by virtue of the conflict-of-laws rules of the forum State, a second issue arises concerning the effect of commencement of insolvency proceedings on security rights. Points that need to be addressed are, for example, whether enforcement of a security right is stayed and whether the security right will be recognized in the insolvency proceedings and, if so, its relative position vis-à-vis other claims. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced (*lex fori concursus*) governs the commencement, conduct (including the ranking of claims), administration and conclusion of the proceedings (the "insolvency effects"; see recommendation 31 of the UNCITRAL Insolvency Guide).

16. The insolvency law governing the ranking of the security right may change the relative priority that a security right would have under secured transactions law, and establish categories of claims that would receive distributions ahead of a security right in insolvency proceedings. When establishing these categories of claims, reference should be made to secured transactions law with regard to the creation, third-party effectiveness, priority and enforcement of the security right before considering the extent, if any, to which the priority of the security right should be affected by the commencement and administration of insolvency proceedings. Irrespective of issues of ranking of rights, a security right might nevertheless be subject to the avoidance provisions of the insolvency law (see recommendation 88 of the UNCITRAL Insolvency Guide).

(b) *Exceptions to the lex fori concursus*

17. While the insolvency effects of insolvency proceedings on security rights typically are governed by the *lex fori concursus*, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable

property is located (the *lex situs* or *lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The UNCITRAL Insolvency Guide addresses these exceptions in more detail (see UNCITRAL Insolvency Guide part two, chapter I, paras. 85-90), but does not recommend the adoption of a *lex situs* rule for insolvency effects as applied to attachments to immovable property or even to movable property in general. Instead, it generally recommends that any exceptions to the applicability of the *lex fori concursus* for insolvency effects should be limited in number and clearly set forth in the insolvency law (see UNCITRAL Insolvency Guide, recommendation 34 and part two, chapter I, para. 88).

5. Treatment of encumbered assets

18. A security right may be affected following the commencement of insolvency proceedings by the provisions of insolvency law that define the scope of or otherwise address several matters. Such matters include, for example: the assets of the debtor that are subject to the insolvency proceedings; application of a stay or suspension of actions against the debtor; post-commencement finance; avoidance of transactions that took place before commencement of the proceedings; approval of a reorganization plan; and ranking of claims.

(a) Identification of assets subject to the proceedings

19. Identification of assets of the debtor that will be subject to insolvency proceedings is key to the successful conduct of the proceedings. Assets that are controlled by an insolvency representative and subject to the insolvency proceedings form the “estate” (see the term “assets of the debtor” in para. 20 below). So, the UNCITRAL Insolvency Guide recommends that the estate formed on commencement of the proceedings will typically include all property, rights and interests of the debtor, including rights and interests in property, whether tangible (movable or immovable) or intangible, wherever located (domestic or foreign), and whether or not in the possession of the debtor at the time of commencement. The debtor’s rights and interests in encumbered assets and in third party-owned assets, as well as assets acquired by the debtor or the insolvency representative after commencement of the proceedings and assets recovered through avoidance actions, should also be included in the estate (see UNCITRAL Insolvency Guide, recommendation 35).

(i) Encumbered assets

20. The inclusion in the estate of the debtor’s rights and interests in encumbered assets may assist in ensuring not only the equal treatment of creditors similarly situated, but also the achievement of the goals of the insolvency proceedings where, for example, the asset in question is essential for the reorganization of the debtor or sale of the debtor’s business as a going concern in liquidation. The UNCITRAL Insolvency Guide discusses the assets of the debtor to be included in the estate (as well as those assets to be excluded) and the effect of commencement of insolvency proceedings on encumbered assets. It emphasizes, in particular, the importance to a successful reorganization of including in the insolvency estate the debtor’s interest in encumbered assets and third-party-owned

assets (for the meaning of the term “assets of the debtor”, see section B.1 below; for a discussion of the estate, see UNCITRAL Insolvency Guide, part two, chapter II, paras. 7-9) and of applying a stay on commencement to certain actions with respect to security rights (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 36-40, 56, 57 and 59-69, and recommendation 46, as well as paras. 26 and 27 below).

(ii) *Assets acquired after commencement of insolvency proceedings*

21. The UNCITRAL Insolvency Guide provides that an asset acquired by the debtor after the commencement of insolvency proceedings generally is part of the insolvency estate (see recommendation 35, subparagraph (b)).

22. Accordingly, even though the secured creditor may have a security right in future assets of the debtor, the security right should not extend to assets acquired by the debtor after the commencement of the insolvency proceedings (see also recommendation 235 of this *Guide*), unless the secured creditor is providing additional funding. If the security right did extend generally to assets acquired by the debtor after the commencement of the insolvency proceedings, the secured creditor would unfairly benefit from the increase in the encumbered assets that could be available to satisfy the secured obligation resulting from the post commencement acquisition of assets by the debtor without the secured creditor providing any additional credit to the debtor. Likewise, other creditors of the insolvency estate would be unfairly prejudiced if unencumbered assets of the insolvency estate were used after the commencement of the insolvency proceedings to acquire additional assets and those assets were to become automatically subject to the secured creditor’s security right and used to satisfy the secured obligation.

23. However, if the assets acquired by the debtor after the commencement of the insolvency proceedings consist of proceeds of assets in which a secured creditor had a security right that was effective against third parties before the commencement of the insolvency proceedings (or was made effective against third parties after commencement but within any applicable grace period), the security right should extend to those proceeds (see recommendation 236 of this *Guide*). If this were not the case, the secured creditor would not have the benefit of its security right in an encumbered asset that is disposed of or collected after the commencement of the insolvency proceedings and, because of that risk, would be less willing to extend credit to the debtor even where there is no prospect of the commencement of the debtor’s insolvency proceedings.

24. An example may be helpful in illustrating these points. A secured creditor has an unavoidable security right in the debtor’s entire existing and future inventory. After the commencement of insolvency proceedings, the debtor sells immovable property that is not subject to any security right and uses the cash received from the sale to buy inventory. The security right should not extend to this post-commencement inventory. The secured creditor advanced no credit in reliance upon a security right in the new inventory. Permitting the security right to extend to the new inventory would prejudice other creditors of the insolvency estate since the immovable property, an unencumbered asset that was otherwise available to satisfy claims of the other creditors, would have been used to increase the assets available to satisfy the secured obligation.

25. By contrast, if the additional inventory was acquired with cash received by the debtor from the sale of inventory existing on the commencement of the insolvency proceedings and in which the secured creditor had an unavoidable security right, the security right should extend to the inventory acquired after the commencement of the insolvency proceedings. The additional inventory is in effect a substitution for the sold inventory. The secured creditor does not benefit unfairly and other creditors are not unfairly prejudiced.

(b) Protection of the estate by application of a stay

26. Two essential objectives of an effective insolvency law are, first, ensuring that the value of the insolvency estate is not diminished by the actions of various parties and, second, facilitating administration of the estate in a fair and orderly manner (see UNCITRAL Insolvency Guide, recommendation 1). Many insolvency laws achieve these objectives by imposing a stay that prevents the commencement of individual or group actions by creditors to enforce their claims or pursue any remedies or proceedings against the debtor or property of the estate, and suspends any such actions already under way. Where the stay applies from the commencement of the insolvency proceedings (see UNCITRAL Insolvency Guide, recommendation 46), it can be complemented by provisional measures of relief that can be ordered by the court to ensure protection of the assets of the debtor and the collective interest of creditors between the time when an application to commence insolvency proceedings has been filed and the time it is acted on by the court (see UNCITRAL Insolvency Guide, recommendations 39-45). The UNCITRAL Insolvency Guide discusses the scope of actions to which a mandatory or provisional stay applies (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 30-40); time and duration (including extension) of the stay (see part two, chapter II, paras. 41-53 and 58); and measures to protect the interests of secured creditors (see part two, chapter II, paras. 59-69; see also UNCITRAL Insolvency Guide, recommendations 39-51).

(i) Scope of the stay

27. A number of States extend the stay to all actions against the debtor, whether judicial or not, including those by secured creditors and third-party owners. The stay usually extends to actions to enforce a security right by repossessing and selling, leasing or otherwise disposing of the encumbered assets (or exercising another enforcement remedy set out in chapter VIII of this *Guide* on the enforcement of a security right). It also extends to actions to create a security right or to make a security right effective against third parties (see UNCITRAL Insolvency Guide, recommendation 46). Some insolvency laws distinguish between liquidation and reorganization in terms of application and duration of the stay to actions by secured creditors or third-party owners. A growing number of insolvency laws recognize that, notwithstanding that limiting the enforcement of security rights may have an adverse impact on the cost and availability of credit, excluding actions by secured creditors from the stay could frustrate the basic objectives of the insolvency proceedings. This is true particularly in reorganization, since very often the debtor's continued use of encumbered assets is essential to the operation of the business and therefore to its reorganization. Any negative effects of the stay can be mitigated by measures to ensure that the economic value of the encumbered assets is protected against diminution (see paras. 31-34 below).

28. Where a security right was effective against third parties at the time the insolvency proceedings commenced, it is necessary to exempt from the application of the stay any action that the secured creditor may need to take to ensure that effectiveness continues. For example, the secured transactions law may provide a grace period for registration of certain security rights, such as acquisition security rights, in the general security rights registry (see recommendations 180 and 192 of this *Guide*); the stay generally should not interfere with registration within such a grace period (even if the grace period ends after the commencement of the insolvency proceedings).

(ii) Duration of the stay

29. In reorganization proceedings, subject to the safeguards discussed below, it is desirable that the stay apply to security rights for a sufficient period of time. This is necessary to ensure orderly administration of the reorganization without encumbered assets being removed from the estate before it can be determined whether those assets are necessary for the reorganization.

30. It is also desirable that the stay apply to security rights in liquidation proceedings, in particular to facilitate sale of the business as a going concern. The UNCITRAL Insolvency Guide recommends that the stay should apply for a short period of time (for example, 30-60 days) that is clearly set forth in the insolvency law, with provision for the court to provide an extension in certain limited circumstances (see UNCITRAL Insolvency Guide, recommendation 49).

(iii) Protection of secured creditors

31. An insolvency law should include safeguards to protect secured creditors where the economic value of their security rights is adversely affected by the stay (see UNCITRAL Insolvency Guide, recommendation 50). One of those safeguards may take the form of relief from the stay or a release of the encumbered asset. Even absent a request for relief from the stay, it is desirable that an insolvency law provide that a secured creditor is entitled to protection against the diminution in value of the encumbered asset and that the court may grant appropriate measures to ensure that protection.

32. The UNCITRAL Insolvency Guide recommends that grounds for relief from the stay or release of the encumbered asset could include cases where, for example, the encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business; the value of the encumbered asset is diminishing as a result of the commencement of the insolvency proceedings and the secured creditor is not protected against that diminution of value; and, in reorganization, a plan is not approved within any applicable time limit (see UNCITRAL Insolvency Guide, recommendation 51). Some insolvency laws also provide that, once relief has been granted and the stay has been lifted with respect to a particular encumbered asset, the asset may be released to the secured creditor. In such an event, the secured creditor would be free to enforce its security right against such asset under applicable law. Any surplus value remaining after payment of the secured obligation would be part of the estate.

33. Central to the notion of protecting the value of encumbered assets from diminution is the mechanism for determining both the value of those assets and the time at which valuation takes place, depending upon the purpose for which the determination is required. Assets may need to be valued at different times during the insolvency proceedings, such as at commencement with the value being reviewed during the course of the proceedings. The basis on which the valuation should be made is also an issue (for example, going concern or liquidation value). The value of an encumbered asset may, at least in the first instance, be determined by pre-commencement agreement of the parties or may require determination by the court on the basis of evidence, including a consideration of markets, market conditions and expert testimony.

34. The UNCITRAL Insolvency Guide discusses the timing of valuation and different valuation mechanisms (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 66-68).

(c) Use and disposal of encumbered assets

35. Secured creditors will have an ongoing interest in the manner in which encumbered assets are treated following commencement of insolvency proceedings. Treatment of these assets will depend on the provisions of the insolvency law with respect, for example, to the following matters: application of the stay, further encumbrance of encumbered assets, use of assets during the course of the insolvency proceedings, sale or disposal of assets, relinquishment of assets and sale of encumbered assets free and clear of any security rights.

36. The UNCITRAL Insolvency Guide recommends that the insolvency law should permit encumbered assets to be used and disposed of or further encumbered in insolvency proceedings. It sets out recommendations about the conditions under which encumbered assets may be sold free of security rights (for example, the condition that the security right in an asset extends to the proceeds of the sale of the asset) and the protections to be afforded to secured creditors whose encumbered assets are so sold, including the need to notify secured creditors about any proposed sale or other disposal of encumbered assets and to give them an opportunity to object (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 74-89, and recommendations 52-59).

6. Post-commencement finance

37. In both liquidation and reorganization proceedings, an insolvency representative may require access to funds to continue to operate the business. The estate may have insufficient liquid assets to cover anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables) and that are not subject to pre-existing security rights effective against third parties. Where there are insufficient unencumbered liquid assets or anticipated cash flow, the insolvency representative must seek financing from third parties. Often, these parties are the same lenders that extended credit to the debtor prior to the commencement of insolvency proceedings, and typically they will only be willing to extend the necessary credit if they receive appropriate assurance (either in the form of a priority claim on, or priority security rights in, the assets of the estate) that they will be repaid.

38. In any of these financing arrangements (referred to collectively as “post-commencement finance”), it is essential that the rights of pre-commencement secured creditors in the economic value of the encumbered assets be appropriately protected against diminution. While some States permit, in limited circumstances, the creation of a security right to secure post-commencement finance that ranks ahead of a pre-existing security right, the UNCITRAL Insolvency Guide recommends that the creation of such a security right (sometimes referred to as a “priming lien”) should be permitted only where certain conditions are met, including that the rights of pre-commencement secured creditors in the economic value of the encumbered assets are protected against diminution. Post-commencement finance is addressed in some detail in part two, chapter II, paras. 94-107, and recommendations 63-68, of the UNCITRAL Insolvency Guide.

7. *Treatment of contracts*

(a) *Automatic termination or acceleration clauses*

39. Parties to security agreements have an interest in the treatment in insolvency proceedings of clauses that define events of default giving rise to automatic termination or acceleration of payments under the agreement. Although some insolvency laws permit those clauses to be overridden when insolvency proceedings commence, this approach has not yet become a general feature of insolvency laws. The inability to interfere with general principles of contract law in this way, however, may make reorganization impossible where the contract relates, for example, to an asset that is necessary for reorganization or the sale of a business as a going concern. The UNCITRAL Insolvency Guide recommends that such clauses should be unenforceable as against the insolvency representative and the debtor (see UNCITRAL Insolvency Guide, recommendation 70).

40. Any negative impact of a policy of overriding these types of clause can be balanced by providing compensation to creditors that can demonstrate that they have suffered damage or loss as a result of a contract continuing to be performed after commencement of insolvency proceedings or providing an exception to a general override of such clauses for certain types of contract. The UNCITRAL Insolvency Guide recommends that the contracts excepted from a general override should include financial contracts and that special rules should be required in the case of labour contracts (see UNCITRAL Insolvency Guide, recommendations 70 and 71).

41. The insolvency law could also provide, for example, that such a clause does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations for the benefit of the debtor after the commencement of the insolvency proceedings. It would not be equitable to require a lender to make loans or other extensions of credit to an insolvent party where the prospect of repayment would be greatly diminished. Requiring the extension of credit after commencement of insolvency proceedings would be especially inequitable if, as described in paragraph 22 above, no additional encumbered assets are being provided to the secured creditor after commencement (see recommendation 237 of this *Guide*).

(b) *Continuation or rejection of contracts*

42. Insolvency laws adopt different approaches to continued performance or rejection of contracts. The UNCITRAL Insolvency Guide makes a number of recommendations relating to the handling of contracts once insolvency proceedings commence. These include recommendations about the procedures for determining whether contracts should continue to be performed or rejected, the treatment of contracts where the debtor is in default on commencement of insolvency proceedings, effects of continuing performance or rejection, leases, assignments of contracts, types of contract for which exceptions might be required and post-commencement contracts (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 108-147, and recommendations 69-86). In any case, what is important for a secured creditor is that rejection of a security agreement does not terminate or otherwise impair the secured obligations already incurred or extinguish the security right and that financial contracts and loan commitments are frequently excepted from the scope of insolvency laws governing the treatment of contracts more generally (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 208-215 and recommendation 101).

8. *Avoidance proceedings*

43. As mentioned above, insolvency law should recognize in principle the effectiveness of a security right that is effective as a matter of secured transactions law. Nevertheless, the security right may be avoidable in insolvency proceedings on the same grounds as any other transaction. For example, a transaction that occurred within a specified period of time prior to commencement of the insolvency proceedings (often referred to as the “suspect period”) may be avoided as a preferential transaction, an undervalued transaction or as a transaction intended to defeat, hinder or delay creditors from collecting on their claims (see UNCITRAL Insolvency Guide, recommendation 87). Thus, if the debtor encumbered its assets to prefer one creditor to another on the eve of the commencement of insolvency proceedings, or without obtaining corresponding value, to the detriment of other creditors, the transaction may be avoided as a preferential or undervalued transaction. The UNCITRAL Insolvency Guide discusses categories of transactions subject to avoidance, the suspect period, conduct of avoidance proceedings and liability of counterparties to avoided transactions (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 148-203, and recommendations 87-99).

44. Examples of security rights that may be subject to avoidance include a security right created shortly before the commencement of insolvency proceedings to secure a pre-existing debt; a security right with respect to which one or more of the steps required to make it effective as against third parties have been taken after the creation of the security right, and after the expiry of any grace period for doing so (see recommendations 180 and 192 of this *Guide*) but within the suspect period; and the acquisition of an encumbered asset by the secured creditor in total or partial satisfaction of the secured obligation (see recommendations 156-159 of this *Guide*) at a price significantly lower than the asset’s actual value.

9. *Participation of secured creditors in insolvency proceedings*

45. Where encumbered assets are part of the insolvency estate and the rights of secured creditors are affected by insolvency proceedings, secured creditors should be entitled to participate in the insolvency proceedings (see UNCITRAL Insolvency Guide, recommendation 126). That participation may take different forms. Under some laws, it includes the right to be heard and to appear in the proceedings, while under other laws, it includes the right to vote on certain specified matters, such as selection (and removal) of the insolvency representative and approval of a reorganization plan, the right to provide advice to the insolvency representative as requested or on matters specified in the insolvency law, and other functions and duties as determined by the insolvency law, the courts or the insolvency representative. In some cases, the extent of a secured creditor's right to vote on certain issues may depend upon whether the secured obligation exceeds the value of the encumbered assets; if the secured creditor is under secured, it might participate as an unsecured creditor to the extent that its obligation is not satisfied from the encumbered asset.

46. The UNCITRAL Insolvency Guide discusses issues of participation of creditors generally and mechanisms that may be used to facilitate that participation (see UNCITRAL Insolvency Guide, part two, chapter III, paras. 75-115. and recommendations 126-137).

10. *Reorganization proceedings*

(a) *Approval of a reorganization plan*

47. Whether or not a secured creditor is entitled to participate in the approval of a reorganization plan will depend upon the manner in which the insolvency law treats secured creditors and, in particular, the extent to which a reorganization plan can modify or impair their security rights and the extent to which the value of the encumbered asset will satisfy the secured creditor's claim. Where the value of the encumbered asset is not sufficient to satisfy the secured creditor's claim, the creditor may participate both as a secured and an unsecured creditor.

48. Where a reorganization plan proposes to impair or modify the rights of secured creditors, they should have the opportunity to vote on approval of that plan (see UNCITRAL Insolvency Guide, recommendation 146). For that purpose, some insolvency laws classify creditors, including secured creditors, according to the nature of their rights and interests. Under some laws, secured creditors vote together as a class separate from unsecured creditors. Under other laws, each secured creditor forms a class of its own.

49. Where secured creditors participate in the approval process, there is a question of whether they are bound by the plan even if they vote against it or abstain from voting. Where secured creditors vote in classes, some insolvency laws provide that, to the extent that the requisite majority of the class votes to approve the plan, dissenting members of the class are bound by the plan, subject to certain protections (for example, they receive at least as much under the plan as they would have received in a liquidation or they are paid in full within a certain period of time with interest at a market rate). The UNCITRAL Insolvency Guide discusses reorganization proceedings in some detail (see part two, chapter IV, paras. 26-75, and recommendations 139-159), including voting by secured creditors (see part two, chapter IV, paras. 34-39, and recommendations 146, 150 and 151).

50. There are several examples of ways in which the economic value of security rights may be preserved in a reorganization plan even though the security rights are being impaired or modified by that plan. If a plan provides for a cash payment or for cash payments in instalments to a secured creditor in total or partial satisfaction of the secured obligation, the cash payment or the present value of the cash instalment payments should not be less than what the secured creditor would have received in liquidation. In determining such value, consideration should be given to the use of the assets and the purpose of the valuation. The basis of such a valuation may include not only the strict liquidation value but also the value of the asset as part of the business as a going concern. For example, if the debtor is going to retain possession of and continue to use the asset under the reorganization plan in order to continue to operate the business as a going concern or if the debtor is going to sell the business as a going concern, this value should be determined by reference to the value of the asset as part of the going-concern business rather than the value of the asset as a single item separate from the business.

51. If the plan provides for the secured creditor to release its security right in some encumbered assets, provision could also be made for substitute assets of at least equal value to become subject to the secured creditor's security right, unless disposal of the remaining encumbered assets would enable the secured creditor to be paid in full.

(b) Valuation of encumbered assets

52. Recommendations 49, subparagraph (c) (ii); 50; 51, subparagraph (b); 54, subparagraph (a); 58, subparagraph (d); 59, subparagraph (c); and 67, subparagraph (c), of the UNCITRAL Insolvency Guide provide generally for the value of encumbered assets to be protected in insolvency proceedings. Recommendation 152, subparagraph (b), of the UNCITRAL Insolvency Guide provides that, under a plan confirmed by a court, all creditors, including secured creditors, should receive at least as much under the plan as they would have received in liquidation. Issues to be considered in determining the value of encumbered assets are discussed in the UNCITRAL Insolvency Guide (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 66-69, and para. 33 above in this chapter).

53. In order to determine the liquidation value of encumbered assets in reorganization proceedings (for the purpose of applying recommendation 152, subparagraph (b), of the UNCITRAL Insolvency Guide), the use of the encumbered assets, the purpose of the valuation and other relevant considerations should be taken into account. The liquidation value of the assets may be based, for example, on their value as part of a going concern (see recommendation 242 of this *Guide*), which may represent a more accurate value of the encumbered assets given the purposes for which they are to be used.

11. Expedited reorganization proceedings

54. In recent years, significant attention has been given to the development of expedited reorganization proceedings (that is, proceedings commenced to give effect to a plan negotiated and agreed to by affected creditors in voluntary restructuring

negotiations that took place prior to commencement of insolvency proceedings, where the insolvency law permits the court to expedite the conduct of those proceedings). Voluntary restructuring negotiations undertaken before the commencement of proceedings will generally involve those creditors, including secured creditors, whose participation is required to ensure an effective reorganization or whose rights are to be affected by the reorganization.

55. The substantive requirements for such expedited reorganization proceedings would include substantially the same safeguards and protections as provided in full, court-supervised reorganization proceedings. However, since the reorganization plan has already been negotiated and agreed to by the requisite majority of creditors at the time the expedited proceedings commence, a number of the procedural provisions of an insolvency law relating to full court-supervised proceedings may be modified or need not apply (see UNCITRAL Insolvency Guide, part two, chapter IV, paras. 87-92, and recommendations 160-168).

12. Treatment of secured claims

56. An important issue for secured creditors is whether they will be required to submit their claims in the insolvency proceedings. Under those insolvency laws that do not include encumbered assets in the insolvency estate and allow secured creditors to enforce their security rights against the encumbered assets freely, secured creditors may be excepted from the requirement to submit a claim. In such cases, they need to file a claim only to the extent that their claim has not been fully satisfied from the value of the sale of the encumbered asset (see UNCITRAL Insolvency Guide, part two, chapter V, paras. 1-50, and recommendations 169-184).

57. Another approach requires secured creditors to submit a claim for the total value of their security rights irrespective of whether any part of the claim is unsecured. That requirement is limited in some laws to the holders of certain types of security right, such as floating charges, bills of sale or security over chattels. Some insolvency laws also permit secured creditors to surrender their security rights to the insolvency representative and submit a claim for the total value of the secured obligation. The rationale of requiring secured creditors to submit claims is to provide information to the insolvency representative as to the existence of all claims, the amount of the secured obligation and the description of the encumbered assets. Whichever approach is chosen, it is desirable that an insolvency law include clear rules on the treatment of secured creditors for the purposes of submission of claims.

58. Where the amount of the claim cannot be, or has not been, determined at the time when the claim is to be submitted, many insolvency laws allow a claim to be admitted provisionally, subject to giving it a notional value (see UNCITRAL Insolvency Guide, recommendation 178). Determining a value for such claims raises a number of issues such as the time at which the value is to be determined and whether it must be liquidated (in which case it will need to be considered by a court) or estimated (which might be undertaken by the insolvency representative, the court or some other appointed person) (see UNCITRAL Insolvency Guide, recommendation 179). Where a court is required to determine the issue, an associated question relates to the court that will be appropriate

(that is, the insolvency court or some other court) and how any delay in reaching a determination can be addressed in terms of its effect on the conduct of the insolvency proceedings. As to timing, many insolvency laws require the valuation to refer to the effective date of commencement of proceedings (see UNCITRAL Insolvency Guide, part two, chapter V, para. 38, and recommendation 179).

13. *Ranking of secured claims*

59. A secured transactions law establishes the priority of security rights as against competing claimants (for the meaning of the terms “competing claimant” and “priority”, see Introduction, section B, Terminology and interpretation of this *Guide*), including other secured and unsecured creditors of a debtor, judgement creditors with a right in encumbered assets and buyers of encumbered assets. Many insolvency laws recognize the pre-insolvency priority of security rights and rank those rights ahead of other claims, such as administration expenses and other claims (for example, for taxes or wages). Such laws provide that secured claims should be satisfied from the proceeds of the sale of the specific encumbered assets or from general funds, depending upon the manner in which the encumbered assets are treated in the insolvency proceedings (see UNCITRAL Insolvency Guide, recommendation 188). However, where the insolvency representative has expended unencumbered resources of the estate in maintaining or preserving the value of the encumbered assets, those expenses may be given a higher ranking even over a secured claim. Accordingly, they may have to be paid out of the proceeds from the sale of or other value attributable to the encumbered assets (see recommendation 241 of this *Guide*).

60. Other insolvency laws rank secured claims after administration costs and other specified (and generally unsecured) claims (for example, for wages or taxes) or limit the amount with respect to which a secured claim will be given a higher ranking to a fixed percentage of the claim. The higher ranking given to certain unsecured claims, which is often based on social policy considerations, has an impact upon the cost and availability of secured credit. The approach of restricting the amount recovered by a secured creditor from the value of the encumbered assets is sometimes taken with respect to a security right in the entirety of a debtor’s assets in order to provide some protection to unsecured creditors (often up to a limited amount).

61. A further approach may permit the ranking of post-commencement secured creditors ahead of the rights of secured creditors existing at the time of commencement (see paras. 37 and 38 above), provided the security rights of pre-existing creditors can be protected (see UNCITRAL Insolvency Guide, recommendations 66 and 67).

62. It is desirable that in situations in which an insolvency law creates special privileges for certain types of claim ranking ahead of security rights (for example, a privilege for payment of tax or other unsecured claims), those privileges be kept to a minimum and clearly stated or referred to in the insolvency law (see recommendation 83 of this *Guide*). This approach will ensure that the insolvency regime is transparent and predictable as to its impact on creditors and will enable secured creditors to assess more accurately the risks associated with extending credit. These issues are

discussed in more detail in the UNCITRAL Insolvency Guide, part two, chapter V, paragraphs 51-79, and recommendations 185-193.

63. As already mentioned, insolvency law usually respects the pre-commencement priority of a security right (where the security right was made effective against third parties prior to commencement or after commencement but within a grace period), subject to any privileges for other claims that may be introduced by insolvency law. The same applies to the priority of security rights established by subordination (that is, a change of priority of a security right by agreement, by order of a court or even unilaterally; see recommendation 240 of this *Guide*). However, subordination should not result in a secured creditor being accorded a ranking higher than the ranking it would have had, whether as an individual creditor or as a member of a class of secured creditors, under applicable non-insolvency law. This principle means that, if secured creditors A, B and C rank in priority so that A is first, B is second and C is third, and A subordinates its secured claim to that of C, B does not obtain a ranking higher than A would have had with respect to the amount of A's claim. In other words, C may exercise A's priority only to the extent of the value of A's claim. This principle also means that, if secured creditor A in class X subordinates its secured claim to secured creditor B in the same class, secured creditor B cannot obtain a ranking higher than the ranking of the class. In other words, B may exercise A's priority only to the extent of the value of A's claim.

14. Acquisition financing

64. The treatment in insolvency of security rights and other rights that function so as to secure the performance of an obligation is a key concern of a buyer's, lessee's or borrower's creditors. This treatment can sometimes vary according to how any particular right is characterized in a secured transactions law; the way in which they are treated in the secured transactions law will generally determine how they are treated in insolvency. Accordingly, the UNCITRAL Insolvency Guide does not address the issue of how these rights are characterized in secured transactions law and addresses only the treatment of such rights in insolvency, given their characterization by secured transactions law.

65. In States that integrate all forms of acquisition financing rights into their secured transactions law (what this *Guide* refers to as the "unitary approach" to acquisition financing), retention-of-title transactions and financial leases are treated in the debtor's insolvency in the same way as an acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law (see recommendation 186 of this *Guide*). The same result would occur, under what this *Guide* refers to as the "non-unitary approach" to acquisition financing, whenever secured transactions law characterizes a transaction as giving rise to a security right (see recommendation 202, alternative A). Accordingly, the provisions of the UNCITRAL Insolvency Guide applicable to security rights would apply to these various acquisition security rights. Where States maintain separately denominated retention-of-title and financial lease transactions, assets subject to these transactions are often not treated by secured transactions law as assets subject to a security right, but rather as assets owned by the seller or the lessor. Accordingly, the provisions of the UNCITRAL Insolvency Guide relating to third-party-owned assets would apply to these transactions (see recommendation 202, alternative B, of this *Guide*).

66. In any case, regardless of whether an acquisition financing right is treated in the insolvency proceedings under the rules applicable to security rights or under the rules applicable to contracts and third-party-owned assets, all acquisition financing rights should be subject to the insolvency effects specified in the UNCITRAL Insolvency Guide. With either alternative of the non-unitary approach (see alternatives A and B of recommendation 202 of this *Guide*), it may be important to note that the UNCITRAL Insolvency Guide often recommends the same treatment for the holders of security rights and third-party-owned assets. This is the case, for example, with respect to recommendation 88 of the UNCITRAL Insolvency Guide (regarding the application of avoidance powers to, among other things, security rights); recommendation 35 (regarding the inclusion of the debtor's rights in encumbered assets of the insolvency estate); recommendations 39-51 (regarding the application of provisional measures and a stay to encumbered assets and relief from the stay); recommendation 52 (regarding use and disposal of assets of the estate, including encumbered assets); recommendation 54 (regarding the use of third party owned assets); and recommendations 69-86 (regarding the treatment of contracts).

15. *Receivables subject to an outright transfer before commencement*

67. An outright transfer of a receivable is within the scope of the present *Guide* although such a transfer is not made for the purpose of securing the performance of an obligation (see recommendations 3 and 167 of this *Guide*). In any case, irrespective of how it is treated by non-insolvency law, insolvency law treats an outright transfer of a receivable as any other pre-commencement transfer of an asset by the debtor (see generally UNCITRAL Insolvency Guide, recommendation 35, subparagraph (a)).

B. Recommendations

Purpose

The purpose of the recommendations in the present chapter is to address the impact of insolvency on security rights in a comprehensive way that is consistent with the UNCITRAL Insolvency Guide. Thus, core recommendations from the UNCITRAL Insolvency Guide that relate particularly to security rights are included in this chapter. For a more complete discussion of the impact of insolvency proceedings on security rights, however, this chapter should be read together with both the commentary and the recommendations of the UNCITRAL Insolvency Guide. This chapter also includes discussion of some additional recommendations elaborating on issues discussed in the UNCITRAL Insolvency Guide but not the subject of recommendations in that Guide.

1. UNCITRAL Legislative Guide on Insolvency Law:³ terminology and recommendations

(a) *Terminology*

12. (b) “Assets of the debtor”: property, rights and interests of the debtor, including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor's interests in encumbered assets or in third-party-owned assets;

³United Nations publication, E.05.V.10.

12. (r) “Financial contract”: any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above;
12. (x) “*Lex fori concursus*”: the law of the State in which the insolvency proceedings are commenced;
12. (y) “*Lex situs*”: the law of the State in which the asset is situated;
12. (z) “Netting”: the setting-off of monetary or non-monetary obligations under financial contracts;
12. (aa) “Netting agreement”: a form of financial contract between two or more parties that provides for one or more of the following:
- (i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;
 - (ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or
 - (iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements.⁴
12. (dd) “Party in interest”: any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest;
12. (ff) “Preference”: a transaction which results in a creditor obtaining an advantage or irregular payment;
12. (gg) “Priority”: the right of a claim to rank ahead of another claim where that right arises by operation of law;
12. (hh) “Priority claim”: a claim that will be paid before payment of general unsecured creditors;
12. (ii) “Protection of value”: measures directed at maintaining the economic value of encumbered assets and third-party-owned assets during the insolvency proceedings (in some jurisdictions referred to as “adequate protection”). Protection may be provided by way of cash payments, provision of security interests over alternative or additional assets or by other means as determined by a court to provide the necessary protection;
12. (pp) “Security interest”: a right in an asset to secure payment or other performance of one or more obligations.

⁴United Nations Assignment Convention, article 5, subparagraph 1.

*(b) Recommendations**Key objectives of an efficient and effective insolvency law*

1. In order to establish and develop an effective insolvency law, the following key objectives should be considered:

- (a) Provide certainty in the market to promote economic stability and growth;
- (b) Maximize value of assets;
- (c) Strike a balance between liquidation and reorganization;
- (d) Ensure equitable treatment of similarly situated creditors;
- (e) Provide for timely, efficient and impartial resolution of insolvency;
- (f) Preserve the insolvency estate to allow equitable distribution to creditors;
- (g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and
- (h) Recognize existing creditors' rights and establish clear rules for ranking of priority claims.

4. The insolvency law should specify that where a security interest is effective and enforceable under law other than the insolvency law, it will be recognized in insolvency proceedings as effective and enforceable.

7. In order to design an effective and efficient insolvency law, the following common features should be considered:

(a)-(d) ...

(e) Protection of the insolvency estate against the actions of creditors, the debtor itself and the insolvency representative and, where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(f)-(r) ...

Law applicable to validity and effectiveness of rights and claims

30. The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be determined by the private international law rules of the State in which insolvency proceedings are commenced.

Law applicable in insolvency proceedings: lex fori concursus

31. The insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

(a)-(i) ...

(j) Treatment of secured creditors;

(k)-(n) ...

(o) Ranking of claims;

(p)-(s) ...

Exceptions to the application of the law of the insolvency proceedings

...

34. Any exceptions additional to recommendations 32 and 33 should be limited in number and be clearly set forth or noted in the insolvency law.

Assets constituting the insolvency estate

35. The insolvency law should specify that the estate should include:

- (a) Assets of the debtor,⁵ including the debtor's interest in encumbered assets and in third-party-owned assets;
- (b) Assets acquired after commencement of the insolvency proceedings; and
- (c) ...

Provisional measures⁶

39. The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor⁷ or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings,⁸ including:

- (a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;
- (b)-(d) ...

Indemnification in connection with provisional measures

40. The insolvency law may provide the court with the power to:

- (a) Require the applicant for provisional measures to provide indemnification and, where appropriate, to pay costs or fees; or
- (b) Impose sanctions in connection with an application for provisional measures.

Balance of rights between the debtor and insolvency representative

41. The insolvency law should clearly specify the balance of the rights and obligations between the debtor and any insolvency representative appointed as a provisional measure. Between the time an application for commencement of insolvency proceedings is made and commencement of those proceedings, the debtor is entitled to continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

⁵Ownership of assets would be determined by reference to the relevant applicable law, where the term "assets" is defined broadly to include property, rights and interest of the debtor, including the debtor's rights and interests in third-party-owned assets.

⁶These articles follow the corresponding articles of the UNCITRAL Model Law on Cross-Border Insolvency, see article 19 (see annex III of the UNCITRAL Insolvency Guide).

⁷The reference to assets in paragraphs (a)-(c) is intended to be limited to assets that would be part of the insolvency estate once proceedings commence.

⁸The insolvency law should indicate the time of effect of an order for provisional measures, for example, at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time (see the UNCITRAL Insolvency Guide, part two, chapter II, para. 44).

Notice

42. The insolvency law should specify that, unless the court limits or dispenses with the need to provide notice, appropriate notice is to be given to those parties in interest affected by:

- (a) An application or court order for provisional measures (including an application for review and modification or termination); and
- (b) A court order for additional measures applicable on commencement, unless the court limits or dispenses with the need to provide notice.

Ex parte provisional measures

43. The insolvency law should specify that, where the debtor or other party in interest affected by a provisional measure is not given notice of the application for that provisional measure, the debtor or other party in interest affected by the provisional measures has the right, upon urgent application, to be heard promptly⁹ on whether the relief should be continued.

Modification or termination of provisional measures

44. The insolvency law should specify that the court, at its own motion or at the request of the insolvency representative, the debtor, a creditor or any other person affected by the provisional measures, may review and modify or terminate those measures.

Termination of provisional measures

45. The insolvency law should specify that provisional measures terminate when:

- (a) An application for commencement is denied;
- (b) An order for provisional measures is successfully challenged under recommendation 43; and
- (c) The measures applicable on commencement take effect, unless the court continues the effect of the provisional measures.

Measures applicable on commencement

46. The insolvency law should specify that, on commencement of insolvency proceedings:¹⁰

- (a) Commencement or continuation of individual actions or proceedings¹¹ concerning the assets of the debtor and the rights, obligations or liabilities of the debtor are stayed;
- (b) Actions to make security interests effective against third parties and to enforce security interests are stayed;¹²

⁹Any time limit included in the insolvency law should be short in order to prevent the loss of value of the debtor's business.

¹⁰These measures would generally be effective as at the time of the making of the order for commencement.

¹¹See UNCITRAL Model Law on Cross-Border Insolvency, article 20 (see annex III of the UNCITRAL Insolvency Guide). It is intended that the individual actions referred to in subparagraph (a) of recommendation 46 would also cover actions before an arbitral tribunal. It may not always be possible, however, to implement the automatic stay of arbitral proceedings, such as where the arbitration does not take place in the State but in a foreign location.

¹²If law other than the insolvency law permits those security interests to be made effective within certain specified time periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the specified time period. Where law other than the insolvency law does not include such time periods, the stay applicable on commencement would operate to prevent the security interest from being made effective (for further discussion, the UNCITRAL Insolvency Guide, part two, chapter II, para. 32, and this *Guide*)

- (c) Execution or other enforcement against the assets of the estate is stayed;
 - (d) The right of a counterparty to terminate any contract with the debtor is suspended;¹³
- and
- (e) The right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.¹⁴

Duration of measures automatically applicable on commencement

49. The insolvency law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout those proceedings until:

- (a) The court grants relief from the measures;¹⁵
- (b) In reorganization proceedings, a reorganization plan becomes effective;¹⁶ or
- (c) In the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires,¹⁷ unless it is extended by the court for a further period on a showing that:
 - (i) An extension is necessary to maximize the value of assets for the benefit of creditors; and
 - (ii) The secured creditor will be protected against diminution of the value of the encumbered asset in which it has a security interest.

Protection from diminution of the value of encumbered assets

50. The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the asset in which it has a security interest. The court may grant appropriate measures of protection that may include:

- (a) Cash payments by the estate;
- (b) Provision of additional security interests; or
- (c) Such other means as the court determines.

Relief from measures applicable on commencement

51. The insolvency law should specify that a secured creditor may request the court to grant relief from the measures applicable on commencement of insolvency proceedings on grounds that may include that:

- (a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) The value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; and
- (c) In reorganization, a plan is not approved within any applicable time limits.

¹³See UNCITRAL Insolvency Guide, part two, chapter II, paras. 114-119. This recommendation is not intended to preclude the termination of a contract if the contract provides for a termination date that happens to fall after the commencement of insolvency proceedings.

¹⁴The limitation on the right to transfer, encumber or otherwise dispose of assets of the estate may be subject to an exception in those cases where the continued operation of the business by the debtor is authorized and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.

¹⁵Relief should be granted on the grounds included in recommendation 51 of the UNCITRAL Insolvency Guide.

¹⁶A plan may become effective upon approval by creditors or following confirmation by the court, depending upon the requirements of the insolvency law (see UNCITRAL Insolvency Guide, part two, chapter IV, paras. 54 and following).

¹⁷It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the insolvency law should clearly state the period of application.

Power to use and dispose of assets of the estate

52. The insolvency law should permit:

- (a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and
- (b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

Further encumbrance of encumbered assets

53. The insolvency law should specify that an encumbered asset may be further encumbered, subject to the requirements of recommendations 65-67.

Use of third-party-owned assets

54. The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

- (a) The interests of the third party will be protected against diminution in the value of the asset; and
- (b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.

Ability to sell assets of the estate free and clear of encumbrances and other interests

58. The insolvency law should permit the insolvency representative to sell an asset that is encumbered or subject to other interest free and clear of that encumbrance and other interest, outside the ordinary course of business, provided that:

- (a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;
- (b) The holder is given the opportunity to be heard by the court where they object to the proposed sale;
- (c) Relief from the stay has not been granted; and
- (d) The priority of interests in the proceeds of sale of the asset is preserved.

Use of cash proceeds

59. The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

- (a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or
- (b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and
- (c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

Burdensome assets

62. The insolvency law should permit the insolvency representative to determine the treatment of any asset that is burdensome to the estate. In particular, the insolvency law may permit the insolvency representative to relinquish a burdensome asset following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset and the asset is not required for a reorganization or sale of the business as a going concern, the insolvency law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

Attracting and authorizing post-commencement finance

63. The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate. The insolvency law may require the court to authorize or creditors to consent to the provision of post-commencement finance.

Security for post-commencement finance

65. The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower-priority security interest on an already encumbered asset of the estate.

66. The law¹⁸ should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

67. The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

- (a) The existing secured creditor was given the opportunity to be heard by the court;
- (b) The debtor can prove that it cannot obtain the finance in any other way; and
- (c) The interests of the existing secured creditor will be protected.¹⁹

Effect of conversion on post-commencement finance

68. The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.²⁰

¹⁸This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

¹⁹See UNCITRAL Insolvency Guide, part two, chapter II, paras. 63-69.

²⁰The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.

Automatic termination and acceleration clauses

70. The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

- (a) An application for commencement, or commencement, of insolvency proceedings;
- (b) The appointment of an insolvency representative.²¹

71. The insolvency law should specify the contracts that are exempt from the operation of recommendation 70, such as financial contracts, or subject to special rules, such as labour contracts.

Continuation or rejection

72. The insolvency law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where continuation would be beneficial to the insolvency estate.²² The insolvency law should specify that:

- (a) The right to continue applies to the contract as a whole; and
- (b) The effect of continuation is that all terms of the contract are enforceable.

73. The insolvency law may permit the insolvency representative to decide to reject a contract.²³ The insolvency law should specify that the right to reject applies to the contract as a whole.

Continuation of contracts where the debtor is in breach

79. The insolvency law should specify that where the debtor is in breach of a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach and the estate is able to perform under the continued contract.

Performance prior to continuation or rejection

80. The insolvency law should specify that the insolvency representative may accept or require performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted or required by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

- (a) If the counterparty has performed the contract, the amount of the administrative expense should be the contractual price of the performance; or
- (b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against diminution of the value of those assets and have an administrative claim in accordance with subparagraph (a).

²¹This recommendation would apply only to those contracts where such clauses could be overridden (see UNCITRAL Insolvency Guide, part two, chapter II, paras. 143-145, on exceptions) and is not intended to be exclusive, but to establish a minimum: the court should be able to examine other contractual clauses that would have the effect of terminating a contract on the occurrence of similar events.

²²Provided the automatic stay on commencement of proceedings applies to prevent termination (pursuant to an automatic termination clause) of contracts with the debtor, all contracts should remain in place to enable the insolvency representative to consider the possibility of continuation, unless the contract has a termination date that happens to fall after the commencement of insolvency proceedings.

²³An alternative to providing a power to reject contracts is the approach of those jurisdictions that provide that performance of a contract simply ceases unless the insolvency representative decides to continue its performance.

Damages for subsequent breach of a continued contract

81. The insolvency law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

Damages arising from rejection

82. The insolvency law should specify that any damages arising from the rejection of a pre-commencement contract would be determined in accordance with applicable law and should be treated as an ordinary unsecured claim. The insolvency law may limit claims relating to the rejection of a long-term contract.

Assignment of contracts

83. The insolvency law may specify that the insolvency representative can decide to assign a contract, notwithstanding restrictions in the contract, provided the assignment would be beneficial to the estate.

84. Where the counterparty objects to assignment of a contract, the insolvency law may permit the court to nonetheless approve the assignment provided:

- (a) The insolvency representative continues the contract;
- (b) The assignee can perform the assigned contractual obligations;
- (c) The counterparty is not substantially disadvantaged by the assignment; and
- (d) The debtor's breach under the contract is cured before assignment.

85. The insolvency law may specify that, where the contract is assigned, the assignee will be substituted for the debtor as the contracting party with effect from the date of the assignment and the estate will have no further liability under the contract.

Avoidable transactions²⁴

87. The insolvency law should include provisions that apply retroactively and are designed to overturn transactions, involving the debtor or assets of the estate, and that have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The insolvency law should specify the following types of transaction as avoidable:

(a) Transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the effect of the transaction was to put assets beyond the reach of creditors or potential creditors or to otherwise prejudice the interests of creditors;

(b) Transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was a gift or was made in exchange for a nominal or less-than-equivalent value or for inadequate value that occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

(c) Transactions involving creditors where a creditor obtained, or received the benefit of, more than its pro rata share of the debtor's assets that occurred at a time when the debtor was insolvent (preferential transactions).

²⁴The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, granting of a security interest, a guarantee, a loan or a release or an action to make a security interest effective against third parties and may include a composite series of transactions.

Avoidance of security interests

88. The insolvency law should specify that, notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

Transactions exempt from avoidance actions

92. The insolvency law should specify the transactions that are exempt from avoidance, including financial contracts.

Financial contracts and netting

103. Once the financial contracts of the debtor have been terminated, the insolvency law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

Participation by creditors

126. The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

Right to be heard and to request review

137. The insolvency law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled:

- (a) To object to any act that requires court approval;
- (b) To request review by the court of any act for which court approval was not required or not requested; and
- (c) To request any relief available to it in insolvency proceedings.

Right of appeal²⁵

138. The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

*Reorganization plan**Voting mechanisms*

145. The insolvency law should establish a mechanism for voting on approval of the plan. The mechanism should address the creditors and equity holders who are entitled to vote on the plan; the manner in which the vote will be conducted, either at a meeting convened for that purpose

²⁵In accordance with the key objectives, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings.

or by mail or other means, including electronic means and the use of proxies; and whether or not creditors and equity holders should vote in classes according to their respective rights.

146. The insolvency law should specify that a creditor or equity holder whose rights are modified or affected by the plan should not be bound to the terms of the plan unless that creditor or equity holder has been given the opportunity to vote on approval of the plan.

147. The insolvency law should specify that where the plan provides that the rights of a creditor or equity holder or class of creditors or equity holders are not modified or affected by a plan, that creditor or equity holder or class of creditors or equity holders is not entitled to vote on approval of the plan.

148. The insolvency law should specify that creditors entitled to vote on approval of the plan should be separately classified according to their respective rights and that each class should vote separately.

149. The insolvency law should specify that all creditors and equity holders in a class should be offered the same treatment.

Approval by classes

150. Where voting on approval of the plan is conducted by reference to classes, the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring approval by all classes or approval by a specified majority of the classes, but at least one class of creditors whose rights are modified or affected by the plan must approve the plan.

151. Where the insolvency law does not require a plan to be approved by all classes, the insolvency law should address the treatment of those classes which do not vote to approve a plan that is otherwise approved by the requisite classes. That treatment should be consistent with the grounds set forth in recommendation 152.

Confirmation of an approved plan

152. Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

(a) The requisite approvals have been obtained and the approval process was properly conducted;

(b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;

(c) The plan does not contain provisions contrary to law;

(d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and

(e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

Challenges to approval (where there is no requirement for confirmation)

153. Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit parties in interest, including the debtor, to challenge

the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed, which should include:

- (a) Whether the grounds set forth in recommendation 152 are satisfied; and
- (b) Fraud, in which case the requirements of recommendation 154 should apply.

Secured claims

172. The insolvency law should specify whether secured creditors are required to submit claims.

Unliquidated claims

178. The insolvency law should permit unliquidated claims to be admitted provisionally, pending determination of the amount of the claim by the insolvency representative.

Valuation of secured claims

179. The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

Secured claims

188. The insolvency law should specify that a secured claim should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

2. Additional insolvency recommendations

Assets acquired after commencement of insolvency proceedings

235. Except as provided in recommendation 236, the insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings is not subject to a security right created by the debtor before the commencement of the insolvency proceedings.

236. The insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings with respect to the debtor is subject to a security right created by the debtor before the commencement of the insolvency proceedings to the extent the asset constitutes proceeds (whether cash or non-cash) of an encumbered asset that was an asset of the debtor before commencement.

Automatic termination clauses in insolvency proceedings

237. If the insolvency law provides that a contract clause that, upon the commencement of insolvency proceedings or the occurrence of another insolvency-related event, automatically terminates any obligation under a contract or accelerates the maturity of any obligation under a contract, is unenforceable as against the insolvency representative or the debtor, the insolvency law should also provide that such provision does not render unenforceable or invalidate a

contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations to the benefit of the debtor.

Third-party effectiveness of a security right in insolvency proceedings

238. The insolvency law should provide that, if a security right is effective against third parties at the time of the commencement of insolvency proceedings, action may be taken after the commencement of the insolvency proceedings to continue, preserve or maintain the effectiveness against third parties of the security right to the extent and in the manner permitted under the secured transactions law.

Priority of a security right in insolvency proceedings

239. The insolvency law should provide that, if a security right is entitled to priority under law other than insolvency law, the priority continues unimpaired in insolvency proceedings except if, pursuant to insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to recommendation 188 of the UNCITRAL Insolvency Guide.

Effect of a subordination agreement in insolvency proceedings

240. The insolvency law should provide that, if a holder of a security right in an asset of the insolvency estate subordinates its priority unilaterally or by agreement in favour of any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the debtor to the same extent that such subordination is effective under non-insolvency law.

Costs and expenses of maintaining value of the encumbered asset in insolvency proceedings

241. The insolvency law should provide that the insolvency representative is entitled to recover on a first priority basis from the value of an encumbered asset reasonable costs and expenses incurred by the insolvency representative in maintaining, preserving or increasing the value of the encumbered asset for the benefit of the secured creditor.

Valuation of encumbered assets in reorganization proceedings

242. The insolvency law should provide that, in determining the liquidation value of encumbered assets in reorganization proceedings, consideration should be given to the use of those assets and the purpose of the valuation. The liquidation value of those assets may be based on their value as part of a going concern.

Annex I

Terminology and recommendations of the *UNCITRAL Legislative Guide on Secured Transactions*

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Terminology*

“Acknowledgement” with respect to a right to receive the proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a demand for payment (“draw”) under an independent undertaking has, unilaterally or by agreement:

(a) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the right to receive the proceeds under an independent undertaking; or

(b) Obligated itself to pay or otherwise give value to the secured creditor upon a draw under an independent undertaking;

“Acquisition secured creditor” (a term used in the context of both the unitary and the non-unitary approaches to acquisition financing) means a secured creditor that has an acquisition security right. In the context of the unitary approach, the term includes a retention-of-title seller or financial lessor (terms used in the context of the non-unitary approach);

“Acquisition security right” (a term used in the context of both the unitary and the non-unitary approaches to acquisition financing) means a security right in a tangible asset (other than a negotiable instrument or negotiable document) that secures the obligation to pay any unpaid portion of the purchase price of the asset or an obligation incurred or credit otherwise provided to enable the grantor to acquire the asset. An acquisition security right need not be denominated as such. Under the unitary approach, the term includes a right that is a retention-of-title right or a financial lease right (terms used in the context of the non-unitary approach);

“Assignee” means a person to which an assignment of a receivable is made;¹

“Assignment” means the creation of a security right in a receivable that secures the payment or other performance of an obligation. While an assignment that is an outright transfer does not secure the payment or other performance of an obligation, for convenience of reference the term also includes an outright transfer of a receivable;²

“Assignor” means a person that makes an assignment of a receivable;

“Attachment to a movable asset” means a tangible asset that is physically attached to another tangible asset but has not lost its separate identity;

*The terminology is part of the commentary (see Introduction, section B, on terminology and interpretation). For the meaning of the term “the law” or “this law”, see recommendation 1.

¹For the terms “assignee”, “assignor” and “assignment”, see also article 2, subparagraph (a), of the United Nations Assignment Convention.

²See the term “security right”, as well as recommendation 3, and the relevant commentary.

“Attachment to immovable property” means a tangible asset that is so physically attached to immovable property that, despite the fact that it has not lost its separate identity, it is treated as immovable property under the law of the State where the immovable property is located;

“Bank account” means an account maintained by a bank, to which funds may be credited. The term includes a checking or other current account, as well as a savings or time deposit account. The term also includes a right to the payment of funds transferred to the bank by way of anticipatory reimbursement of a future payment obligation to which the bank has committed and a right to the payment of funds transferred to the bank by way of cash collateral securing an obligation owed to the bank to the extent that the transferor of those funds has a claim to them, if under national law the bank’s obligation is a bank account. The term does not include a right against the bank to payment evidenced by a negotiable instrument;

“Competing claimant”³ means a creditor of a grantor that is competing with another creditor of the grantor having a security right in an encumbered asset of the grantor and includes:

- (a) Another creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);
- (b) In the context of the non-unitary approach to acquisition financing, the seller or financial lessor of the same encumbered asset that has retained title to it;
- (c) Another creditor of the grantor that has a right in the same encumbered asset;
- (d) The insolvency representative in the insolvency proceedings in respect of the grantor;⁴ or
- (e) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset;

“Confirmer” means a bank or other person that adds its own independent undertaking to that of a guarantor/issuer;⁵

“Consumer goods” means goods that a grantor uses or intends to use for personal, family or household purposes;

“Control” with respect to a right to payment of funds credited to a bank account exists:

- (a) Automatically upon the creation of a security right if the depositary bank is the secured creditor;
- (b) If the depositary bank has concluded a control agreement with the grantor and the secured creditor; or
- (c) If the secured creditor is the account holder;

³For the term “competing claimant”, see also article 5, subparagraph (m), of the United Nations Assignment Convention.

⁴In the chapter on the impact of insolvency on a security right (chapter XII of this *Guide*), reference is made to “the insolvency of the debtor” for reasons of consistency with the terminology used in the UNCITRAL Insolvency Guide.

⁵In line with article 6, subparagraph (e), of the *United Nations Convention on Independent Guarantees and Stand-by Letters of Credit* (United Nations publication, Sales No. E.97.V.12), a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer.

“Control” with respect to a right to receive the proceeds under an independent undertaking exists:

(a) Automatically upon the creation of a security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or

(b) If the guarantor/issuer, confirmer or nominated person has made an acknowledgement in favour of the secured creditor;

“Control agreement” means an agreement between a depositary bank, a grantor and a secured creditor, evidenced by a signed writing,⁶ according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent from the grantor;

“Debtor” means a person that owes performance of a secured obligation and includes a secondary obligor such as a guarantor of a secured obligation. The debtor may or may not be the person that creates the security right (see the term “grantor” below);

“Debtor of the receivable” means a person liable for payment of a receivable and includes a guarantor or other person secondarily liable for payment of the receivable;⁷

“Encumbered asset” means a tangible or intangible asset that is subject to a security right. The term also includes a receivable that has been the subject of an outright transfer;⁸

“Equipment” means a tangible asset used by a person in the operation of its business;

“Financial contract” means any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above;⁹

“Financial lease right” (a term used only in the context of the non-unitary approach to acquisition financing) means a lessor’s right in a tangible asset (other than a negotiable instrument or negotiable document) that is the object of a lease agreement under which, at the end of the lease:

(a) The lessee automatically becomes the owner of the asset that is the object of the lease;

⁶For the meaning of the term “signed writing” in the context of electronic communications, see recommendations 11 and 12.

⁷See also article 2, subparagraph (a), of the United Nations Assignment Convention. A guarantor in an accessory guarantee is not only a debtor of the receivable of which it has guaranteed the payment, but also a debtor of the receivable constituted by the guarantee, as an accessory guarantee is itself a receivable (that is, there are two receivables).

⁸See the term “security right”, as well as recommendation 3, and the relevant commentary.

⁹See article 5, subparagraph (k), of the United Nations Assignment Convention; see also the relevant term in the UNCITRAL Insolvency Guide. The reference in this term to “any other transaction similar to any transaction referred to above entered into in financial markets” is intended to include the full range of transactions entered into in financial markets. The term is flexible. It includes any transaction entered into in financial markets under which payment rights are determined by reference to: (a) underlying asset classes; or (b) quantitative measures of economic or financial risk or value associated with an occurrence or contingency. Examples are transactions under which payment rights are determined by reference to weather statistics, freight rates, emissions allowances or economic statistics.

(b) The lessee may acquire ownership of the asset by paying no more than a nominal price; or

(c) The asset has no more than a nominal residual value.

The term includes a hire-purchase agreement, even if not nominally referred to as a lease, provided that it meets the requirements of subparagraph (a), (b) or (c);

“Grantor” means a person that creates a security right to secure either its own obligation or that of another person.¹⁰ Under the unitary approach to acquisition financing, the term “grantor” of an acquisition security right includes a retention-of-title buyer or financial lessee. Although an assignor in an outright transfer of a receivable does not assign the receivable in order to secure the performance of an obligation, for convenience of reference the term also includes an assignor in an outright transfer of a receivable;¹¹

“Guarantor/issuer” means a bank or other person that issues an independent undertaking;

“Independent undertaking” means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (including a demand or first-demand bank guarantee, or a counter-guarantee) or any other undertaking recognized as independent by law or practice rules such as the United Nations Guarantee and Stand-by Convention, the Uniform Customs and Practice for Documentary Credits, the Rules on International Standby Practices and the Uniform Rules for Demand Guarantees;

“Insolvency court” means a judicial or other authority competent to control or supervise insolvency proceedings;

“Insolvency estate” means the assets of a debtor subject to insolvency proceedings;

“Insolvency proceedings” means collective proceedings, subject to insolvency court supervision, either for reorganization or liquidation;

“Insolvency representative” means a person or body, including one appointed on an interim basis, authorized in insolvency proceedings to administer the reorganization or the liquidation of the insolvency estate;

“Intangible asset” means all types of movable asset other than tangible assets and includes incorporeal rights, receivables and rights to the performance of obligations other than receivables;

“Intellectual property” means copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset considered to be intellectual property under the

¹⁰See the term “debtor”.

¹¹See the term “security right”, as well as recommendation 3 and the relevant commentary.

domestic law of the enacting State or under an international agreement to which the enacting State is a party;¹²

“Inventory” means tangible assets held for sale or lease in the ordinary course of a person’s business, as well as raw and semi-processed materials (work-in-process);

“Issuer” of a negotiable document means the person that is obligated to deliver the tangible assets covered by the document under the law governing negotiable documents, whether or not that person has agreed to perform all obligations arising from the document;

“Knowledge” means actual rather than constructive knowledge;

“Mass or product” means tangible assets other than money that are so physically associated or united with other tangible assets that they have lost their separate identity;

“Money” means currency currently authorized as legal tender by any State. It does not include funds credited to a bank account or negotiable instruments such as cheques;

“Negotiable document” means a document, such as a warehouse receipt or a bill of lading, that embodies a right to delivery of tangible assets and satisfies the requirements for negotiability under the law governing negotiable documents;

“Negotiable instrument” means an instrument, such as a cheque, bill of exchange or promissory note, that embodies a right to payment and satisfies the requirements for negotiability under the law governing negotiable instruments;¹³

“Netting agreement” means an agreement between two or more parties that provides for one or more of the following:

(a) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;

(b) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market value, conversion of such sums into a single currency and netting into a single payment by one party to the other; or

¹²The term “intellectual property” is intended to ensure consistency of the *Guide* with intellectual property laws and treaties, while at the same time respecting the right of legislators in a State enacting the recommendations of the *Guide* to align the meaning of this term with that State’s own law and international obligations. An enacting State may add to this list or remove from it types of intellectual property to conform it to national law. The reference to international agreements is intended to refer to agreements such as the Convention Establishing the World Intellectual Property Organization and the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS”). In order to clarify that these terms and the recommendations referring to them apply only to tangible assets (and not to intangible assets such as intellectual property), reference is made to “tangible assets” in the terms “acquisition security right”, “retention-of-title right” and “financial lease right”. In the term “receivable”, no reference is made to “the performance of non-monetary obligations” in order to clarify the understanding that the term and the recommendations relating to receivables apply only to receivables and not, for example, to the rights of a licensee or the obligations of a licensor under a contractual licence of intellectual property.

¹³The *Guide* was prepared against the background of negotiable instruments and negotiable documents in paper form, in view of the particular difficulty of creating an electronic equivalent of paper-based negotiability. However, the *Guide* should not be interpreted as discouraging the use of electronic equivalents of paper negotiable instruments or negotiable documents. Thus, an enacting State that wishes to address this matter will need to devise special rules. For the same reason, the *United Nations Convention on the Use of Electronic Communications in International Contracts* does not address the electronic equivalent of paper-based negotiability (see United Nations publication, Sales No. E.07.V.2, explanatory note, para. 7).

(c) The set-off of amounts calculated as set forth in subparagraph (b) above under two or more netting agreements;¹⁴

“Nominated person” means a bank or other person that is identified in an independent undertaking by name or type (for example, “any bank in country X”) as being nominated to give value under an independent undertaking and that acts pursuant to that nomination and, in the case of a freely available independent undertaking, any bank or other person;

“Notice” means a communication in writing;¹⁵

“Notification of the assignment” means a communication in writing that reasonably identifies the assigned receivable and the assignee;¹⁶

“Original contract” means, in the context of a receivable created by contract, the contract between the assignor and the debtor of the receivable from which the receivable arises;

“Possession” (except as the term is used in recommendations 28 and 51-53, with respect to the issuer of a negotiable document) means only the actual possession of a tangible asset by a person or an agent or employee of that person, or by an independent person that acknowledges holding it for that person. It does not include non-actual possession described by terms such as constructive, fictive, deemed or symbolic possession;

“Priority” means the right of a person to derive the economic benefit of its security right in preference to the right of a competing claimant;

“Proceeds” means whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or licence of an encumbered asset, proceeds of proceeds, natural and civil fruits or revenues, dividends, distributions, insurance proceeds and claims arising from defects in, damage to or loss of an encumbered asset;¹⁷

“Receivable” means a right to payment of a monetary obligation, excluding a right to payment evidenced by a negotiable instrument, a right to receive the proceeds under an independent undertaking and a right to payment of funds credited to a bank account;¹⁸

“Retention-of-title right” (a term used only in the context of the non-unitary approach to acquisition financing) means a seller’s right in a tangible asset (other than a negotiable instrument or a negotiable document) pursuant to an arrangement with the buyer by which ownership of the asset is not transferred (or is not transferred irrevocably) from the seller to the buyer until the unpaid portion of the purchase price is paid;

¹⁴See article 5, subparagraph (l), of the United Nations Assignment Convention.

¹⁵For the electronic equivalents of the terms “writing” and “signed writing”, see recommendations 11 and 12.

¹⁶As to when notification of the assignment is effective, see recommendation 118.

¹⁷See article 5, subparagraph (j), of the United Nations Assignment Convention.

¹⁸See article 2, subparagraph (a), of the United Nations Assignment Convention. It should be noted that, while the Convention applies only to contractual receivables, the *Guide* applies to non-contractual receivables as well (see chapter I on scope, para. 6); for the exclusion of bank deposits, letters of credit and negotiable instruments, see article 4, subparagraphs 2 (f) and 2 (g), and paragraph 3, respectively, of the United Nations Assignment Convention.

“Right to receive the proceeds under an independent undertaking” means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be paid or delivered by the guarantor/issuer, confirmer or nominated person giving value for a draw under an independent undertaking. The term also includes the right to receive payment in connection with the purchase by a negotiating bank of a negotiable instrument or a document under a complying presentation. The term does not include:

- (a) The right to draw under an independent undertaking; or
- (b) What is received upon honour of an independent undertaking;¹⁹

“Secured creditor” means a creditor that has a security right. Although an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference the term also includes the assignee in an outright transfer of a receivable;²⁰

“Secured obligation” means an obligation secured by a security right;

“Secured transaction” means a transaction that creates a security right. Although an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference the term also includes an outright transfer of a receivable;²¹

“Security agreement” means an agreement, in whatever form or terminology, between a grantor and a creditor that creates a security right. Although an outright transfer of a receivable does not secure the performance of an obligation, for convenience of reference the term also includes an agreement for the outright transfer of a receivable;²²

“Security right” means a property right in a movable asset that is created by agreement and secures payment or other performance of an obligation, regardless of whether the parties have denominated it as a security right. In the context of the unitary approach to acquisition financing, the term includes both acquisition security rights and non-acquisition security rights. In the context of the non-unitary approach to acquisition financing, it does not include a retention-of-title or financial lease right. Although an outright transfer of a receivable does not secure payment or other performance of an obligation, for convenience of reference the term “security right” also includes the right of the assignee in an outright transfer of a receivable.²³ The term does not include a personal right against a guarantor or other person liable for the payment of the secured obligation;

“Subsequent assignment” means an assignment by the initial or any other assignee.²⁴ In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee;

¹⁹A security right in the right to receive the proceeds under an independent undertaking (as an original encumbered asset) is different from a security right in “proceeds” (a key concept of the *Guide*) of assets covered in the *Guide* (see the term “proceeds” and recommendation 19). Thus, what is received upon honour of (that is, as a result of a complying presentation under) an independent undertaking constitutes the “proceeds” of the right to receive the proceeds under an independent undertaking.

²⁰See the term “security right”, as well as recommendation 3, and the relevant commentary.

²¹Ibid.

²²Ibid.

²³See recommendation 3 and the relevant commentary.

²⁴See article 2, subparagraph (b), of the United Nations Assignment Convention.

“Tangible asset” means every form of corporeal movable asset. Among the categories of tangible asset are inventory, equipment, consumer goods, attachments, negotiable instruments, negotiable documents and money.

Key objectives of an effective and efficient secured transactions law*

1. In order to provide a broad policy framework for an effective and efficient secured transactions law (the “secured transactions law” is hereinafter referred to as “the law” or “this law”), the law should be designed:

- (a) To promote low-cost credit by enhancing the availability of secured credit;
- (b) To allow debtors to use the full value inherent in their assets to support credit;
- (c) To enable parties to obtain security rights in a simple and efficient manner;
- (d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions;
- (e) To validate non-possessory security rights in all types of asset;
- (f) To enhance certainty and transparency by providing for registration of a notice of a security right in a general security rights registry;
- (g) To establish clear and predictable priority rules;
- (h) To facilitate efficient enforcement of a secured creditor’s rights;
- (i) To allow parties maximum flexibility to negotiate the terms of their security agreement;
- (j) To balance the interests of all persons affected by a secured transaction; and
- (k) To harmonize secured transactions laws, including conflict-of-laws rules relating to secured transactions.

I. Scope of application, basic approaches to secured transactions and general themes common to all chapters of the *Guide*

Purpose

The purpose of provisions on the scope of application of the law is to establish a single comprehensive regime for secured transactions. The provisions specify the security rights and other rights to which the law applies. The purpose of provisions on basic approaches to security is to ensure that the law:

- (a) Applies to all contractually created rights in movable assets that secure the payment or other performance of an obligation (“functional approach”); and
- (b) Provides for the appropriate implementation of the functional approach so as to ensure that all providers of secured credit are treated according to rules that produce functionally equivalent outcomes.

*The key objectives could be included in a preamble or other statement accompanying the secured transactions law enacting the recommendations of the *Guide* to provide guidance on the underlying legislative policies to be taken into account in the interpretation and application of the secured transactions law.

Scope of application

2. Subject to recommendations 3-7,²⁵ the law should apply to all rights in movable assets created by agreement that secure payment or other performance of an obligation, regardless of the form of the transaction, the type of the movable asset, the status of the grantor or secured creditor or the nature of the secured obligation. Thus, the law should apply to:

(a) Security rights in all types of movable asset, tangible or intangible, present or future, including inventory, equipment and other tangible assets, contractual and non-contractual receivables, contractual non-monetary claims, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking and intellectual property;

(b) Security rights created or acquired by all legal and natural persons, including consumers, without, however, affecting rights under consumer-protection legislation;

(c) Security rights securing all types of obligation, present or future, determined or determinable, including fluctuating obligations and obligations described in a generic way; and

(d) All property rights created contractually to secure the payment or other performance of an obligation, including transfers of title to tangible assets for security purposes, assignments of receivables for security purposes, the various forms of retention-of-title agreements and financial leases.

The law should also apply to security rights in proceeds of encumbered assets.

Outright transfers of receivables

3. The law should apply to outright transfers of receivables despite the fact that such transfers do not secure the payment or other performance of an obligation. This recommendation is subject to the exception provided in recommendation 167 (chapter VIII on the enforcement of a security right).

Limitations on scope

4. Notwithstanding recommendation 2, the law should not apply to:

(a) Aircraft, railway rolling stock, space objects and ships, as well as other categories of mobile equipment in so far as such asset is covered by a national law or an international agreement to which the State enacting legislation based on these recommendations (herein referred to as “the State” or “this State”) is a party and the matters covered by this law are addressed in that national law or international agreement;

(b) Intellectual property in so far as the provisions of the law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property;

²⁵Where reference in a recommendation is made to a recommendation found in a different chapter, the reference includes the number and subject of the chapter in which that other recommendation is found. Where no such reference is made, the recommendation referred to is in the same chapter as the recommendation that contains the reference.

- (c) Securities;
 - (d) Payment rights arising under or from financial contracts governed by netting agreements, except a receivable owed on the termination of all outstanding transactions; and
 - (e) Payment rights arising under or from foreign exchange transactions.
5. The law should not apply to immovable property. However, recommendations 21, 25 (chapter II on the creation of a security right), 43, 48 (chapter III on the effectiveness of a security right against third parties) 87, 88 (chapter V on the priority of a security right) 164, 165 (chapter VIII on the enforcement of a security right) 184, 195 and 196 (chapter IX on acquisition financing) may affect immovable property.
6. The law should provide that if, under other law, a security right in an excluded type of asset (for example, immovable property) extends to a type of proceeds to which this law applies (for example, receivables), this law applies to the security right in the proceeds except to the extent that that other law applies to that security right.
7. The law should not include any other limitations on its scope of application. To the extent any other limitations are introduced, they should be set out in the law in a clear and specific way.

Functional approach

8. The law should adopt a functional approach, under which it covers all rights in movable assets that are created by agreement and secure the payment or other performance of an obligation, regardless of the form of the transaction or the terminology used by the parties (including rights of transferees under a transfer of title to tangible assets for security purposes, rights of an assignee under an assignment of receivables for security purposes, as well as rights of sellers or financial lessors under various forms of retention-of-title agreements and financial leases, respectively). Except with respect to acquisition financing, the functional approach should be implemented in a way that classifies all rights securing the performance of an obligation as security rights and subjects them to a common set of rules.
9. With respect to acquisition financing, the functional approach may be implemented either:
- (a) In a way that classifies as acquisition security rights all rights in movable assets that secure the payment or other performance of an obligation, and that makes them subject to a common set of rules (“the unitary approach”); or
 - (b) In a way that classifies (under the approach referred to as “the non-unitary approach”):
 - (i) As acquisition security rights all rights in movable assets that secure the payment or other performance of an obligation other than the rights of a seller under a retention-of-title agreement and of a lessor under a financial lease; and
 - (ii) As ownership rights the rights of a seller under a retention-of-title agreement and of a lessor under a financial lease, but makes those ownership rights subject to rules that produce outcomes that are the functional equivalent of the

outcomes produced with respect to acquisition security rights, thereby ensuring that all providers of acquisition financing are treated equally.

Party autonomy

10. The law should provide that, except as otherwise provided in recommendations 14, 15 (chapter II on the creation of a security right), 111-112 (chapter VI on the rights and obligations of the parties to a security agreement), 132-136 (chapter VIII on the enforcement of a security right), 178-186 (chapter IX on acquisition financing, option A: unitary approach), 187-202 (chapter IX on acquisition financing, option B: non-unitary approach), 203-215 and 217-227 (chapter X on conflict of laws), the secured creditor and the grantor or the debtor may derogate from or vary by agreement its provisions relating to their respective rights and obligations. Such an agreement does not affect the rights of any person that is not a party to the agreement.²⁶

Electronic communications

11. The law should provide that, where it requires that a communication or a contract should be in writing, or provides consequences for the absence of a writing, that requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference.

12. The law should provide that, where the law requires that a communication or a contract should be signed by a person, or provides consequences for the absence of a signature, that requirement is met in relation to an electronic communication if:

(a) A method is used to identify the person and to indicate that person's intention in respect of the information contained in the electronic communication; and

(b) The method used is either:

(i) As reliable as appropriate for the purpose for which the electronic communication was generated or communicated, in the light of all the circumstances, including any relevant agreement; or

(ii) Proven in fact to have fulfilled the functions described in subparagraph (a) above, by itself or together with further evidence.²⁷

II. Creation of a security right (effectiveness as between the parties)

Purpose

The purpose of provisions on the creation of a security right is to specify the requirements that must be satisfied in order for a security right to be effective between the parties.

²⁶See article 6 of the United Nations Assignment Convention.

²⁷For recommendations 11 and 12, see article 9, paragraphs 2 and 3, of the *United Nations Convention on the Use of Electronic Communications in International Contracts*.

A. *General recommendations**

Creation of a security right

13. The law should provide that a security right in an asset is created by an agreement concluded between the grantor and the secured creditor. In the case of an asset with respect to which the grantor has rights or the power to encumber at the time of the conclusion of the agreement, the security right in that asset is created at that time. In the case of an asset with respect to which the grantor acquires rights or the power to encumber thereafter, the security right in that asset is created when the grantor acquires rights in the asset or the power to encumber the asset.

Minimum content of a security agreement

14. The law should provide that a security agreement must:

- (a) Reflect the intent of the parties to create a security right;
- (b) Identify the secured creditor and the grantor;
- (c) Describe the secured obligation;
- (d) Describe the encumbered assets in a manner that reasonably allows their identification; and
- (e) Indicate the maximum monetary amount for which the security right may be enforced, if the State determines that such an indication would be helpful in order to facilitate subordinate lending.

Form of the security agreement

15. The law should provide that a security agreement may be oral if accompanied by the secured creditor's possession of the encumbered asset. Otherwise, the agreement must be concluded in or evidenced by a writing that, by itself or in conjunction with the course of conduct between the parties, indicates the grantor's intent to create a security right.

Obligations secured by a security right

16. The law should provide that a security right may secure any type of obligation, whether present or future, determined or determinable, conditional or unconditional, fixed or fluctuating.

Assets subject to a security right

17. The law should provide that a security right may encumber any type of asset, including parts of assets and undivided rights in assets. A security right may encumber assets that, at the time the security agreement is concluded, may not yet exist or that the grantor may not yet own or have the power to encumber. It may also encumber all assets of a

*The general recommendations apply to security rights in all types of asset covered in the *Guide*, as modified by the asset-specific recommendations.

grantor. Any exceptions to these rules should be limited and described in the law in a clear and specific way.

18. The law should provide that, except as provided in recommendations 23-25, it does not override provisions of any other law to the extent that they limit the creation or enforcement of a security right in, or the transferability of, specific types of asset.

Continuation of a security right in proceeds

19. The law should provide that, unless otherwise agreed by the parties to a security agreement, a security right in an encumbered asset extends to its identifiable proceeds (including proceeds of proceeds).

Commingled proceeds

20. The law should provide that, where proceeds in the form of money or funds credited to a bank account have been commingled with other assets of the same kind so that the proceeds are no longer identifiable, the amount of the proceeds immediately before they were commingled is nevertheless to be treated as identifiable proceeds after commingling. However, if, at any time after commingling, the total amount of the asset is less than the amount of the proceeds, the total amount of the asset at the time that its amount is lowest plus the amount of any proceeds later commingled with the asset is to be treated as identifiable proceeds.

Creation and continuation of a security right in an attachment

21. The law should provide that a security right may be created in a tangible asset that is an attachment at the time of creation of the security right or continues in a tangible asset that becomes an attachment subsequently. A security right in an attachment to immovable property may be created under this law or under the law governing immovable property.

Continuation of a security right into a mass or product

22. The law should provide that a security right created in tangible assets before they are commingled in a mass or product continues in the mass or product. The amount secured by a security right that continues in the mass or product is limited to the value of the encumbered assets immediately before they became part of the mass or product.

B. Asset-specific recommendations

Effectiveness of a bulk assignment of receivables and an assignment of a future receivable or a part of or an undivided interest in a receivable

23. The law should provide that:

(a) An assignment of contractual receivables that are not specifically identified, a future receivable or a part of or an undivided interest in a receivable is effective as between

the assignor and the assignee and as against the debtor of the receivable as long as, at the time of the assignment or, in the case of a future receivable, at the time it arises, it can be identified to the assignment to which it relates; and

(b) Unless otherwise agreed, an assignment of one or more future receivables is effective without a new act of transfer being required to assign each receivable.²⁸

Effectiveness of an assignment of a receivable made despite an anti-assignment clause

24. The law should provide that:

(a) An assignment of a receivable is effective as between the assignor and the assignee and as against the debtor of the receivable notwithstanding an agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting in any way the assignor's right to assign its receivables;

(b) Nothing in this recommendation affects any obligation or liability of the assignor for breach of the agreement mentioned in subparagraph (a) of this recommendation, but the other party to such an agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(c) This recommendation applies only to assignments of receivables:

(i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;

(ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(iii) Representing the payment obligation for a credit card transaction; or

(iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

Creation of a security right in a personal or property right that secures a receivable, a negotiable instrument or any other intangible asset

25. The law should provide that:

(a) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right that secures payment or other performance of the receivable, negotiable instrument or intangible asset automatically, without further action by either the grantor or the secured creditor;

(b) If the personal or property right is an independent undertaking, the security right automatically extends to the right to receive the proceeds under the independent undertaking but does not extend to the right to draw under the independent undertaking;

(c) This recommendation does not affect a right in immovable property that under other law is transferable separately from a receivable, negotiable instrument or other intangible asset that it may secure;

²⁸For recommendations 23-25, see articles 8-10 of the United Nations Assignment Convention.

(d) A secured creditor with a security right in a receivable, negotiable instrument or any other intangible asset covered by this law has the benefit of any personal or property right that secures payment or other performance of the receivable, negotiable instrument or other intangible asset notwithstanding any agreement between the grantor and the debtor of the receivable or the obligor of the negotiable instrument or other intangible asset limiting in any way the grantor's right to create a security right in the receivable, negotiable instrument or other intangible asset, or in any personal or property right securing payment or other performance of the receivable, negotiable instrument or other intangible asset;

(e) Nothing in this recommendation affects any obligation or liability of the grantor for breach of the agreement mentioned in subparagraph (d) of this recommendation, but the other party to such an agreement may not avoid the contract from which the receivable, negotiable instrument or other intangible asset arises, or the security agreement creating the personal or property security right on the sole ground of that breach. A person that is not a party to such an agreement is not liable on the sole ground that it had knowledge of the agreement;

(f) Subparagraphs (d) and (e) of this recommendation apply only to security rights in receivables, negotiable instruments or other intangible assets:

- (i) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of immovable property;
- (ii) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;
- (iii) Representing the payment obligation for a credit card transaction; or
- (iv) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties;

(g) Subparagraph (a) of this recommendation does not affect any duties of the grantor to the debtor of the receivable or to the obligor of the negotiable instrument or other intangible asset; and

(h) To the extent that the automatic effects under subparagraph (a) of this recommendation and recommendation 48 are not impaired, this recommendation does not affect any requirement under other law relating to the form or registration of the creation of a security right in any asset, securing payment or other performance of a receivable, negotiable instrument or other intangible asset that is not covered by this law.

Creation of a security right in a right to payment of funds credited to a bank account

26. The law should provide that a security right in a right to payment of funds credited to a bank account is effective notwithstanding an agreement between the grantor and the depositary bank limiting in any way the grantor's right to create such a security right. However, the depositary bank has no duty to recognize the secured creditor and no obligation is otherwise imposed on the depositary bank with respect to the security right without the depositary bank's consent.²⁹

²⁹For the depositary bank's rights and obligations, see recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors).

Creation of a security right in a right to receive the proceeds under an independent undertaking

27. The law should provide that a beneficiary of an independent undertaking may create a security right in a right to receive the proceeds under an independent undertaking, even if the right to draw under the independent undertaking is itself not transferable under the law and practice governing independent undertakings. The creation of a security right in a right to receive the proceeds under an independent undertaking is not a transfer of the right to draw under an independent undertaking.

Extension of a security right in a negotiable document to the tangible asset covered by the negotiable document

28. The law should provide that a security right in a negotiable document extends to the tangible asset covered by the document, provided that the issuer is in possession of the asset, directly or indirectly, at the time the security right in the document is created.

III. Effectiveness of a security right against third parties

Purpose

The purpose of provisions on the effectiveness of a security right against third parties is to create a foundation for the predictable, fair and efficient ordering of priority by:

(a) Requiring registration as a precondition for the effectiveness of a security right against third parties, except where exceptions and alternatives to registration are appropriate in light of countervailing commercial policy considerations; and

(b) Establishing a legal framework to create and support a simple, cost-efficient and effective public registry system for the registration of notices with respect to security rights.

A. General recommendations

Achieving third-party effectiveness

29. The law should provide that a security right is effective against third parties only if it is created and one of the methods for achieving third-party effectiveness referred to in recommendation 32, 34 or 35 has been followed.

Effectiveness against the grantor of a security right that is not effective against third parties

30. The law should provide that a security right that has been created is effective between the grantor and the secured creditor even if it is not effective against third parties.

Continued third-party effectiveness after a transfer of the encumbered asset

31. The law should provide that, after transfer of a right other than a security right in an encumbered asset, a security right in the encumbered asset that is effective against third parties at the time of the transfer continues to encumber the asset except as provided in recommendations 79-81 (chapter V on the priority of a security right), and remains effective against third parties except to the extent otherwise provided under recommendation 62.

General method for achieving third-party effectiveness: registration

32. The law should provide that a security right is effective against third parties if a notice with respect to the security right is registered in the general security rights registry referred to in recommendations 54-75 (chapter IV on the registry system).

33. The law should provide that registration of a notice does not create a security right and is not necessary for the creation of a security right.

Alternatives and exceptions to registration for achieving third-party effectiveness

34. The law should provide that:

(a) A security right may also be made effective against third parties by one of the following alternative methods:

(i) In tangible assets, by the secured creditor's possession, as provided in recommendation 37;

(ii) In movable assets, rights in which are subject to a specialized registration or title certificate system, by registration in the specialized registry or notation on the title certificate, as provided in recommendation 38;

(iii) In an attachment to a movable asset, rights in which subject to a specialized registration or title certificate system, by registration in the specialized registry or notation on the title certificate, as provided in recommendation 42; and

(iv) In an attachment to immovable property, by registration in the immovable property registry, as provided in recommendation 43;

(v) In a right to payment of funds credited to a bank account, by control, as provided in recommendation 49;

(vi) In tangible assets covered by a negotiable document, by the secured creditor's possession of the document, as provided in recommendations 51-53;

(b) A security right is effective against third parties automatically:

(i) In proceeds, if the security right in the original encumbered asset is effective against third parties, as provided in recommendations 39 and 40;

(ii) In an attachment to a movable asset, if the security right in the asset that becomes an attachment was effective against third parties before it became an attachment, as provided in recommendation 41;

(iii) In a mass or product, if the security right in processed or commingled assets was effective against third parties before they became part of the mass or product, as provided in recommendation 44; and

(iv) In movable assets, upon a change in the location of the asset or the grantor to this State, as provided in recommendation 45; and

(c) A security right in a personal or property right that secures payment or other performance of a receivable, negotiable instrument or other intangible asset is effective against third parties, as provided in recommendation 48.

Method for achieving third-party effectiveness of a security right in a right to receive the proceeds under an independent undertaking

35. The law should provide that, except as provided in recommendation 48, a security right in a right to receive the proceeds under an independent undertaking may be made effective against third parties only by control, as provided in recommendation 50.

Different third-party effectiveness methods for different types of asset

36. The law should provide that different methods for achieving third-party effectiveness may be used for different types of encumbered asset, whether they are encumbered pursuant to the same security agreement or not.

Third-party effectiveness of a security right in a tangible asset by possession

37. The law should provide that a security right in a tangible asset may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor's possession.

Third-party effectiveness of a security right in a movable asset subject to a specialized registration or a title certificate system

38. The law should provide that a security right in a movable asset that is subject to registration in a specialized registry or notation on a title certificate under other law may be made effective against third parties by registration as provided in recommendation 32 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

Automatic third-party effectiveness of a security right in proceeds

39. The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset (including any proceeds of proceeds) is effective against third parties automatically when the

proceeds arise, provided that the proceeds are described in a generic way in a registered notice or that the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

40. The law should provide that, if the proceeds are not described in the registered notice as provided in recommendation 39 and do not consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account, the security right in the proceeds continues to be effective against third parties for [a short period of time to be specified] days after the proceeds arise. If the security right in such proceeds is made effective against third parties by one of the methods referred to in recommendation 32 or 34 before the expiry of that time period, the security right in the proceeds continues to be effective against third parties thereafter.

Automatic third-party effectiveness of a security right in an attachment

41. The law should provide that, if a security right in a tangible asset is effective against third parties at the time when the asset becomes an attachment, the security right remains effective against third parties thereafter without any further action.

Third-party effectiveness of a security right in an attachment subject to a specialized registration or a title certificate system

42. The law should provide that a security right in an attachment to a movable asset that is subject to registration in a specialized registry or notation on a title certificate under other law may be made effective against third parties automatically as provided in recommendation 41 or by:

- (a) Registration in the specialized registry; or
- (b) Notation on the title certificate.

Third-party effectiveness of a security right in an attachment to immovable property

43. The law should provide that a security right in an attachment to immovable property may be made effective against third parties automatically as provided in recommendation 41 or by registration in the immovable property registry.

Automatic third-party effectiveness of a security right in a mass or product

44. The law should provide that, if a security right in a tangible asset is effective against third parties at the time when it becomes part of a mass or product, the security right that continues in the mass or product, as provided in recommendation 22 (chapter II on the creation of a security right), is effective against third parties without any further action.

Continuity in third-party effectiveness upon change of location to this State

45. The law should provide that, if a security right in an encumbered asset is effective against third parties under the law of the State in which the encumbered asset or the

grantor is located (whichever determines the applicable law under the conflict-of-laws provisions), and that location changes to this State, the security right continues to be effective against third parties under the law of this State for [a short period of time to be specified] days after the change. If the requirements of the law of this State to make the security right effective against third parties are satisfied prior to the end of that period, the security right continues to be effective against third parties thereafter under the law of this State. For the purposes of any rule of this State in which time of registration or other method of achieving third-party effectiveness is relevant for determining priority, that time is the time when registration or third-party effectiveness was achieved under the law of the State in which the encumbered asset or the grantor was located before its location changed to this State.

Continuity in third-party effectiveness of a security right upon change of method of third-party effectiveness

46. The law should provide that third-party effectiveness of a security right is continuous notwithstanding a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

Lapse in third-party effectiveness or advance registration

47. The law should provide that, if a security right has been made effective against third parties and subsequently there is a period during which the security right is not effective against third parties, third-party effectiveness may be re-established. In such a case, third-party effectiveness takes effect from the time it is re-established. Similarly, if registration made before creation of a security right as provided in recommendation 67 expires as provided in recommendation 69 (chapter IV on the registry system), it may be re-established. In such a case, registration takes effect from the time when the new notice with respect to the security right is registered.

B. Asset-specific recommendations

Third-party effectiveness of a security right in a personal or property right that secures payment of a receivable, negotiable instrument or any other intangible asset

48. The law should provide that, if a security right in a receivable, negotiable instrument or any other intangible asset covered by this law is effective against third parties, such third-party effectiveness extends to any personal or property right that secures payment or other performance of the receivable, negotiable instrument or other intangible asset, without further action by either the grantor or the secured creditor. If the personal or property right is an independent undertaking, its third-party effectiveness automatically extends to the right to receive the proceeds under the independent undertaking (but, as provided in recommendation 25, subparagraph (b), of chapter II on the creation of a security right, the security right does not extend to the right to draw under the independent undertaking). This recommendation does not affect a right in immovable property that under other law is transferable separately from a receivable, negotiable instrument or other intangible asset that it may secure.

Third-party effectiveness of a security right in a right to payment of funds credited to a bank account

49. The law should provide that a security right in a right to payment of funds credited to a bank account may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor obtaining control with respect to the right to payment of funds credited to the bank account.

Third-party effectiveness of a security right in a right to receive the proceeds under an independent undertaking

50. The law should provide that, except as provided in recommendation 48, a security right in a right to receive the proceeds under an independent undertaking may be made effective against third parties only by the secured creditor obtaining control with respect to the right to receive the proceeds under the independent undertaking.

Third-party effectiveness of a security right in a negotiable document or a tangible asset covered by a negotiable document

51. The law should provide that a security right in a negotiable document may be made effective against third parties by registration as provided in recommendation 32 or by the secured creditor's possession of the document.

52. The law should provide that, if a security right in a negotiable document is effective against third parties, the corresponding security right in the asset covered by the document is also effective against third parties. During the period when a negotiable document covers an asset, a security right in the asset may be made effective against third parties by the secured creditor's possession of the document.

53. The law should provide that a security right in a negotiable document that was made effective against third parties by the secured creditor's possession of the document remains effective against third parties for [a short period of time to be specified] days after the negotiable document has been relinquished to the grantor or other person for the purpose of ultimate sale or exchange, loading or unloading, or otherwise dealing with the assets covered by the negotiable document.

IV. The registry system

Purpose

The purpose of provisions on the registry system is to establish a general security rights registry and to regulate its operation. The purpose of the registry system is to provide:

(a) A method by which an existing or future security right in a grantor's existing or future assets may be made effective against third parties;

(b) An efficient point of reference for priority rules based on the time of registration of a notice with respect to a security right; and

(c) An objective source of information for third parties dealing with a grantor's assets (such as prospective secured creditors and buyers, judgement creditors and the grantor's insolvency representative) as to whether the assets may be encumbered by a security right.

To achieve this purpose, the registry system should be designed to ensure that the registration and searching processes are simple, time- and cost-efficient, user-friendly and publicly accessible.

Operational framework of the registration and searching processes

54. The law should ensure that:

(a) Clear and concise guides to registration and searching procedures are widely available and information about the existence and role of the registry is widely disseminated;

(b) Registration is effected by registering a notice that provides the information specified in recommendation 57, as opposed to requiring the submission of the original or a copy of the security agreement or other document;

(c) The registry accepts a notice presented by an authorized medium of communication (for example, paper, electronic) except if:

(i) It is not accompanied by the required fee;

(ii) It fails to provide a grantor identifier sufficient to allow indexing; or

(iii) It fails to provide some information with respect to any of the other items required under recommendation 57;

(d) The registrar does not require verification of the identity of the registrant or the existence of authorization for registration of the notice or conduct further scrutiny of the content of the notice;

(e) The record of the registry is centralized and contains all notices with respect to security rights registered under this law;

(f) The information provided on the record of the registry is available to the public;

(g) A search may be made without the need for the searcher to justify the reasons for the search;

(h) Notices are indexed and can be retrieved by searchers according to the identifier of the grantor;

(i) Fees for registration and for searching, if any, are set at a level no higher than necessary to permit cost recovery;

(j) If possible, the registration system is electronic. In particular:

(i) Notices are stored in electronic form in a computer database;

(ii) Registrants and searchers have immediate access to the registry record by electronic or similar means, including the Internet and electronic data interchange;

(iii) The system is programmed to minimize the risk of entry of incomplete or irrelevant information; and

- (iv) The system is programmed to facilitate speedy and complete retrieval of information and to minimize the practical consequences of human error;
- (k) Registrants may choose among multiple modes and points of access to the registry; and
- (l) The registry, to the extent it is electronic, operates continuously except for scheduled maintenance, and, to the extent it is not electronic, operates during reliable and consistent service hours compatible with the needs of potential registry users.

Security and integrity of the registry

55. In order to ensure the security and integrity of the registry, the law should provide that the operational and legal framework of the registry should reflect the following characteristics:

- (a) Although the day-to-day operation of the registry may be delegated to a private authority, the State retains the responsibility to ensure that it is operated in accordance with the governing legal framework;
- (b) The identity of a registrant is requested and maintained by the registry;³⁰
- (c) The registrant is obligated to forward a copy of a notice to the grantor named in the notice. Failure of the secured creditor to meet this obligation may result only in nominal penalties and any damages resulting from the failure that may be proven;
- (d) The registry is obligated to send promptly a copy of any changes to a registered notice to the person identified as the secured creditor in the notice;
- (e) A registrant can obtain a record of the registration as soon as the registration information is entered into the registry record; and
- (f) Multiple copies of all the information in the records of a registry are maintained and the entirety of the registry records can be reconstructed in the event of loss or damage.

Responsibility for loss or damage

56. The law should provide for the allocation of responsibility for loss or damage caused by an error in the administration or operation of the registration and searching system. If the system is designed to permit direct registration and searching by registry users without the intervention of registry personnel, the responsibility of the registry for loss or damage should be limited to system malfunction.

Required content of notice

57. The law should provide that the following information only is required to be provided in the notice:

- (a) The identifier of the grantor, satisfying the standard provided in recommendations 58-60, and the secured creditor or its representative and their addresses;

³⁰As to the verification of the registrant's identity, see recommendation 54, subparagraph (d).

- (b) A description of the asset covered by the notice, satisfying the standard provided in recommendation 63;
- (c) The duration of the registration as provided in recommendation 69; and
- (d) If the State determines that an indication in the notice of the maximum monetary amount for which the security right may be enforced would be helpful in order to facilitate subordinate lending, a statement of that maximum amount.

Sufficiency of grantor identifier

58. The law should provide that registration of a notice is effective only if it provides the grantor's correct identifier or, in the case of an incorrect statement, if the notice would be retrieved by a search of the registry record under the correct identifier.

59. The law should provide that, where the grantor is a natural person, the identifier of the grantor for the purposes of effective registration is the grantor's name, as it appears in a specified official document. Where necessary, additional information, such as the birth date or identity card number, should be required to uniquely identify the grantor.

60. The law should provide that, where the grantor is a legal person, the grantor's identifier for the purposes of effective registration is the name that appears in the document constituting the legal person.

Impact of a change of the grantor's identifier on the effectiveness of the registration

61. The law should provide that, if, after a notice is registered, the identifier of the grantor changes and as a result the grantor's identifier set forth in the notice does not meet the standard provided in recommendations 58-60, the secured creditor may amend the registered notice to provide the new identifier in compliance with that standard. If the secured creditor does not register the amendment within [a short period of time to be specified] days after the change, the security right is ineffective against:

- (a) A competing security right with respect to which a notice is registered or which is otherwise made effective against third parties after the change in the grantor's identifier but before registration of the amendment; and
- (b) A person that buys, leases or licenses the encumbered asset after the change in the grantor's identifier but before registration of the amendment.

Impact of a transfer of an encumbered asset on the effectiveness of the registration

62. The law should address the impact of a transfer of an encumbered asset on the effectiveness of registration.

Sufficiency of description of an asset covered by a notice

63. The law should provide that a description of an encumbered asset in a notice that meets the requirements of recommendation 14, subparagraph (d) (chapter II on the creation of a security right), is sufficient.

Consequences of an incorrect statement or insufficient description

64. The law should provide that an incorrect statement by the registrant of the identifier or address of the secured creditor or its representative or a description of the encumbered asset that does not meet the requirements of recommendation 63 does not render a registered notice ineffective unless it would seriously mislead a reasonable searcher.

65. The law should provide that a description of certain encumbered assets that does not meet the requirements of recommendation 63 does not render a registered notice ineffective with respect to other assets sufficiently described.

66. The law should provide that an incorrect statement in the notice with respect to the duration of registration and the maximum amount secured, if applicable, does not render a registered notice ineffective. Third parties that relied on such incorrect statements should be protected.

When notice may be registered

67. The law should provide that a notice with respect to a security right may be registered before or after:

- (a) The creation of the security right; or
- (b) The conclusion of the security agreement.

One notice sufficient for multiple security rights arising from multiple agreements between the same parties

68. The law should provide that registration of a single notice is sufficient to achieve third-party effectiveness of one or more than one security right, whether they exist at the time of registration or are created thereafter, and whether they arise from one or more than one security agreement between the same parties.

Duration and extension of the registration of a notice

69. The law should either specify the duration of the effectiveness of the registration of a notice or permit the registrant to specify the duration in the notice at the time of registration and extend it at any time before its expiry. In either case, the secured creditor should be entitled to extend the period of effectiveness of the registration by submitting a notice of amendment to the registry at any point in time before the expiry of the effectiveness of the notice. If the law specifies the duration of effectiveness of the registration, the extension period resulting from the registration of the notice of amendment should be an additional period equal to the initial period. If the law permits the registrant to specify the duration of the effectiveness of the registration, the extension period should be that specified in the notice of amendment.

Time of effectiveness of registration of a notice or amendment

70. The law should provide that registration of a notice or an amendment becomes effective when the information contained in the notice or the amendment is entered into the registry records so as to be available to searchers of the registry record.

Authority for registration

71. The law should provide that registration of a notice is ineffective unless authorized by the grantor in writing. The authorization may be given before or after registration. A written security agreement is sufficient to constitute authorization for the registration. The effectiveness of registration does not depend on the identity of the registrant.

Cancellation or amendment of notice

72. The law should provide that, if no security agreement has been concluded, the security right has been extinguished by full payment or otherwise, or a registered notice is not authorized by the grantor:

(a) The secured creditor is obliged to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant registered notice not later than [a short period of time to be specified] days after the secured creditor's receipt of a written request of the grantor;

(b) The grantor is entitled to seek cancellation or appropriate amendment of the notice through a summary judicial or administrative procedure;

(c) The grantor is entitled to seek cancellation or appropriate amendment of the notice, as provided in subparagraph (b), even before the expiry of the period provided in subparagraph (a), provided that there are appropriate mechanisms to protect the secured creditor.

73. The law should provide that the secured creditor is entitled to submit to the registry a notice of cancellation or amendment, to the extent appropriate, with respect to the relevant registered notice at any time.

74. The law should provide that promptly after a registered notice has expired as provided in recommendation 69 or has been cancelled as provided in recommendation 72 or 73 the information contained in the notice should be removed from the records of the registry that are accessible to the public. However, the information provided in the expired or cancelled or amended notice and the fact of expiration or cancellation or amendment should be archived so as to be capable of retrieval if necessary.

75. The law should provide that, in the case of an assignment of the secured obligation, the notice may be amended to indicate the name of the new secured creditor. However, a notice not so amended remains effective.

V. Priority of a security right

Purpose

The purpose of provisions on the priority of a security right is:

- (a) To provide rules for determining the priority of a security right as against the rights of competing claimants in a predictable, fair and efficient way; and
- (b) To facilitate transactions by which a grantor may create more than one security right in the same asset and thereby use the full value of its assets to obtain credit.

A. General recommendations

Priority between security rights granted by the same grantor in the same encumbered asset

76. The law should provide that priority between competing security rights granted by the same grantor in the same encumbered asset is determined as follows:

- (a) As between security rights that were made effective against third parties by registration of a notice, priority is determined by the order of registration, regardless of the order of creation of the security rights;
- (b) As between security rights that were made effective against third parties otherwise than by registration, priority is determined by the order of third-party effectiveness; and
- (c) As between a security right that was made effective against third parties by registration and a security right that was made effective against third parties otherwise than by registration, priority is determined (regardless of when creation occurs) by the order of registration or third-party effectiveness, whichever occurs first.

This recommendation is subject to the rules provided in recommendations 77, 78 and 87-109, as well as in recommendations 178-185 (chapter IX on acquisition financing, option A: unitary approach).

Priority of a security right registered in a specialized registry or noted on a title certificate

77. The law should provide that a security right in an asset that is made effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 38 (chapter III on the effectiveness of a security right against third parties), has priority as against:

- (a) A security right in the same asset with respect to which a notice is registered in the general security rights registry or which is made effective against third parties by a method other than registration in a specialized registry or notation on a title certificate, regardless of the order; and
- (b) A security right in the same asset that is subsequently registered in the specialized registry or noted on a title certificate.

78. The law should provide that, if an encumbered asset is transferred, leased or licensed and, at the time of transfer, lease or licence, a security right in that asset is effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 38 (chapter III, on the effectiveness of a security right against third parties), the transferee, lessee or licensee takes its rights subject to the security right, except as provided in recommendations 80-82. However, if the security right has not been made effective against third parties by registration in a specialized registry or notation on a title certificate, a transferee, lessee or licensee takes its rights free of the security right.

Priority of rights of transferees, lessees and licensees of an encumbered asset

79. The law should provide that, if an encumbered asset is transferred, leased or licensed and a security right in that asset is effective against third parties at the time of the transfer, lease or licence, a transferee, lessee or licensee takes its rights subject to the security right except as provided in recommendations 78 and 80-82.

80. The law should provide that:

(a) A security right does not continue in an encumbered asset that the grantor sells or otherwise disposes of, if the secured creditor authorizes the sale or other disposition free of the security right; and

(b) The rights of a lessee or licensee of an encumbered asset are not affected by a security right if the secured creditor authorizes the grantor to lease or license the asset unaffected by the security right.

81. The law should provide that:

(a) A buyer of a tangible asset (other than a negotiable instrument or negotiable document) sold in the ordinary course of the seller's business takes free of a security right in the asset, provided that, at the time of the sale, the buyer does not have knowledge that the sale violates the rights of the secured creditor under the security agreement;

(b) The rights of a lessee of a tangible asset (other than a negotiable instrument or document) leased in the ordinary course of the lessor's business are not affected by a security right in the asset, provided that, at the time of the conclusion of the lease, the lessee does not have knowledge that the lease violates the rights of the secured creditor under the security agreement; and

(c) The rights of a non-exclusive licensee of an intangible asset licensed in the ordinary course of the licensor's business are not affected by a security right in the asset, provided that, at the time of the conclusion of the licence agreement, the licensee does not have knowledge that the licence violates the rights of the secured creditor under the security agreement.

82. The law should provide that, if a transferee acquires a right in an encumbered asset free of a security right, any person that subsequently acquires a right in the asset from the transferee also takes its right free of the security right. If the rights of a lessee or licensee are not affected by a security right, the rights of a sub-lessee or sub-licensee are also unaffected by the security right.

Priority of preferential claims

83. The law should limit, both in type and amount, preferential claims arising by operation of law that have priority as against security rights and, to the extent preferential claims exist, they should be described in the law in a clear and specific way.

Priority of rights of judgement creditors

84. The law should provide that a security right has priority as against the rights of an unsecured creditor, unless the unsecured creditor, under other law, obtained a judgement or provisional court order against the grantor and took the steps necessary to acquire rights in the encumbered asset by reason of the judgement or provisional court order before the security right was made effective against third parties. The priority of the security right extends to credit extended by the secured creditor:

(a) Before the expiry of [a short period of time to be specified] days after the unsecured creditor notified the secured creditor that it had taken the steps necessary to acquire rights in the encumbered asset; or

(b) Pursuant to an irrevocable commitment (in a fixed amount or an amount to be fixed pursuant to a specified formula) of the secured creditor to extend credit, if the commitment was made before the unsecured creditor notified the secured creditor that it had taken the steps necessary to acquire rights in the encumbered asset.

This recommendation is subject to the exception in recommendation 183 (chapter IX on acquisition financing, option A: unitary approach).

Priority of rights of persons providing services with respect to an encumbered asset

85. The law should provide that, if other law gives rights equivalent to security rights to a creditor that has provided services with respect to an encumbered asset (for example, by repairing, storing or transporting it), such rights are limited to the asset in the possession of that creditor up to the reasonable value of the services rendered and have priority as against security rights in the asset that were made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter III on the effectiveness of a security right against third parties).

Priority of a supplier's reclamation right

86. The law should provide that, if other law provides that a supplier of tangible assets has the right to reclaim them, the right to reclaim is subordinate to a security right that was made effective against third parties before the supplier exercised its right.

Priority of a security right in an attachment to immovable property

87. The law should provide that a security right or any other right (such as the right of a buyer or lessee) in an attachment to immovable property that is created and made

effective against third parties under immovable property law, as provided in recommendations 21 (chapter II on the creation of a security right) and 43 (chapter III on the effectiveness of a security right against third parties), has priority as against a security right in that attachment that is made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter III on the effectiveness of a security right against third parties).

88. The law should provide that a security right in a tangible asset that is an attachment to immovable property at the time the security right is made effective against third parties or that becomes an attachment to immovable property subsequently, which is made effective against third parties by registration in the immovable property registry as provided in recommendation 43 (chapter III on the effectiveness of a security right against third parties), has priority as against a security right or any other right (such as the right of a buyer or lessee) in the related immovable property that is registered subsequently in the immovable property registry.

Priority of a security right in an attachment to a movable asset

89. The law should provide that a security right or any other right (such as the right of a buyer or lessee) in an attachment to a movable asset that is made effective against third parties by registration in a specialized registry or by notation on a title certificate as provided in recommendation 42 (chapter III on the effectiveness of a security right against third parties) has priority as against a security right or other right in the related movable asset that is subsequently registered in the specialized registry or noted on the title certificate.

Priority of a security right in a mass or product

90. The law should provide that, if two or more security rights in the same tangible asset continue in a mass or product as provided in recommendation 22 (chapter II on the creation of a security right), they retain the same priority as the security rights in the asset had as against each other immediately before the asset became part of the mass or product.

91. The law should provide that, if security rights in separate tangible assets continue in the same mass or product and each security right is effective against third parties, the secured creditors are entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of the respective security rights. For purposes of this formula, the maximum value of a security right is the lesser of the value determined pursuant to recommendation 22 (chapter II on the creation of a security right) and the amount of the secured obligation.

92. The law should provide that an acquisition security right in a separate tangible asset that continues in a mass or product and is effective against third parties has priority as against a security right granted by the same grantor in the mass or product.

Irrelevance of knowledge of the existence of a security right

93. The law should provide that knowledge of the existence of a security right on the part of a competing claimant does not affect priority.³¹

Subordination

94. The law should provide that a competing claimant entitled to priority may at any time subordinate its priority unilaterally or by agreement in favour of any other existing or future competing claimant.

Impact of continuity in third-party effectiveness on priority

95. The law should provide that, for the purpose of recommendation 76, the priority of a security right is not affected by a change in the method by which it is made effective against third parties, provided that there is no time when the security right is not effective against third parties.

96. The law should provide that, if a security right is covered by a registered notice or made effective against third parties and subsequently there is a period during which the security right is neither covered by a registered notice nor effective against third parties, the priority of the security right dates from the earliest time thereafter when the security right is either covered by a registered notice or made effective against third parties.

Priority of security rights securing existing and future obligations

97. The law should provide that, subject to recommendation 84, the priority of a security right extends to all secured obligations, regardless of the time when they are incurred.

Extent of priority

98. The law should provide that, if a State implements recommendation 57, subparagraph (d) (chapter IV on the registry system), the priority of the security right is limited to the maximum amount set out in the registered notice.

Application of priority rules to a security right in a future asset

99. The law should provide that, for purposes of recommendation 76, subparagraphs (a) and (c), the priority of a security right extends to all encumbered assets covered by the registered notice, irrespective of whether they are acquired by the grantor or come into existence before, at or after the time of registration.

³¹As for the impact of knowledge that a transaction violates the rights of a secured creditor, see recommendations 81, 102, subparagraph (b), 105 and 106.

Application of priority rules to a security right in proceeds

100. The law should provide that, for purposes of recommendation 76, the time of third-party effectiveness or the time of registration of a notice as to a security right in an encumbered asset is also the time of third-party effectiveness or registration as to a security right in its proceeds.

B. Asset-specific recommendations*Priority of a security right in a negotiable instrument*

101. The law should provide that a security right in a negotiable instrument that is made effective against third parties by possession of the instrument, as provided in recommendation 37 (chapter III on the effectiveness of a security right against third parties), has priority as against a security right in a negotiable instrument that is made effective against third parties by any other method.

102. The law should provide that a security right in a negotiable instrument that is made effective against third parties by a method other than possession of the instrument is subordinate to the rights of a secured creditor, buyer or other transferee (by agreement) that:

(a) Qualifies as a protected holder under the law governing negotiable instruments; or

(b) Takes possession of the negotiable instrument and gives value in good faith and without knowledge that the transfer is in violation of the rights of the secured creditor under the security agreement.

Priority of a security right in a right to payment of funds credited to a bank account

103. The law should provide that a security right in a right to payment of funds credited to a bank account that is made effective against third parties by control, as provided in recommendation 49 (chapter III on the effectiveness of a security right against third parties), has priority as against a competing security right that is made effective against third parties by any other method. If a depositary bank concludes control agreements with more than one secured creditor, priority among those secured creditors is determined according to the order in which the control agreements are concluded. If the depositary bank is the secured creditor, its security right has priority as against any other security right (including a security right made effective against third parties by a control agreement with the depositary bank even if the depositary bank's security right is later in time) except a security right of a secured creditor that obtains control by becoming the account holder.

104. The law should provide that a right under other law of a depositary bank to set off obligations owed to the depositary bank by the grantor against the grantor's right to payment of funds credited to a bank account has priority as against a security right in the right to payment of funds credited to the bank account except a security right of a secured creditor that obtains control by becoming the account holder.

105. The law should provide that, in the case of a transfer of funds from a bank account initiated by the grantor, the transferee of the funds takes free of a security right in the right to payment of funds credited to the bank account, unless the transferee has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not adversely affect the rights under other law of transferees of funds from bank accounts.

Priority of a security right in money

106. The law should provide that a person that obtains possession of money that is subject to a security right takes the money free of the security right, unless that person has knowledge that the transfer violates the rights of the secured creditor under the security agreement. This recommendation does not adversely affect the rights under other law of holders of money.

Priority of a security right in a right to receive the proceeds under an independent undertaking

107. The law should provide that a security right in a right to receive the proceeds under an independent undertaking that is made effective against third parties by control has priority as against a security right made effective against third parties pursuant to recommendation 48 (chapter III on the effectiveness of a security right against third parties). If control has been achieved by acknowledgement and inconsistent acknowledgements have been given to more than one secured creditor by a person, priority among those security rights is determined according to the order in which the acknowledgements were given.

Priority of a security right in a negotiable document or a tangible asset covered by a negotiable document

108. The law should provide that a security right in a negotiable document and the tangible assets covered thereby is subordinate to any superior rights acquired by a transferee of the document under the law governing negotiable documents.

109. The law should provide that a security right in a tangible asset made effective against third parties by possession of a negotiable document has priority as against a competing security right made effective against third parties by another method. This rule does not apply to a security right in an asset other than inventory if the security right of the secured creditor not in possession of the negotiable document was made effective against third parties before the earlier of:

(a) The time that the asset became covered by the negotiable document; and

(b) The time when an agreement was made between the grantor and the secured creditor in possession of the negotiable document providing for the asset to be covered by a negotiable document so long as the asset became so covered within [a short period of time to be specified] days from the date of the agreement.

VI. Rights and obligations of the parties to a security agreement

Purpose

The purpose of provisions on the rights and obligations of the parties is to enhance efficiency of secured transactions and reduce transaction costs and potential disputes by:

- (a) Providing mandatory rules relating to the rights and obligations of the party in possession of the encumbered asset;
- (b) Providing non-mandatory rules relating to the rights and obligations of the parties that apply in cases where the parties have not addressed these matters in their agreement; and
- (c) Providing non-mandatory rules to serve as a drafting aid or checklist of issues the parties may wish to address in their agreement.

A. *General recommendations*

*Rights and obligations of the parties to a security agreement*³²

110. The law should provide that the mutual rights and obligations of the parties to a security agreement are determined by:

- (a) The terms and conditions set forth in that agreement, including any rules or general conditions referred to therein;
- (b) Any usage to which they have agreed; and
- (c) Unless otherwise agreed, any practices they have established between themselves.

Mandatory rules

111. The law should provide that the party in possession of an encumbered asset must take reasonable steps to preserve the asset and its value.

112. The secured creditor must return an encumbered asset in its possession if, all commitments to extend credit having been terminated, the security right has been extinguished by full payment or otherwise.³³

Non-mandatory rules

113. The law should provide that, unless otherwise agreed, the secured creditor is entitled:

- (a) To be reimbursed for reasonable expenses incurred for the preservation of an encumbered asset in its possession;

³²For recommendation 110, see article 11 of the United Nations Assignment Convention.

³³For the secured creditor's duty to cancel a registered notice, see recommendation 72, chapter IV on the registry system.

- (b) To make reasonable use of an encumbered asset in its possession and to apply the revenues it generates to the payment of the secured obligation; and
- (c) To inspect an encumbered asset in the possession of the grantor.

B. Asset-specific recommendations

*Representations of the assignor*³⁴

114. With respect to an assignment of a contractual receivable, the law should provide that:

- (a) Unless otherwise agreed between the assignor and the assignee, the assignor represents at the time of conclusion of the contract of assignment that:
 - (i) The assignor has the right to assign the receivable;
 - (ii) The assignor has not previously assigned the receivable to another assignee; and
 - (iii) The debtor of the receivable does not and will not have any defences or rights of set-off; and
- (b) Unless otherwise agreed between the assignor and the assignee, the assignor does not represent that the debtor of the receivable has, or will have, the ability to pay.

Right to notify the debtor of the receivable

115. The law should provide that:

- (a) Unless otherwise agreed between the assignor and the assignee, the assignor or the assignee or both may send the debtor of the receivable notification of the assignment and a payment instruction, but after notification has been sent only the assignee may send such an instruction; and
- (b) Notification of the assignment or a payment instruction sent in breach of any agreement referred to in subparagraph (a) of this recommendation is not ineffective for the purposes of recommendation 120 (chapter VII on the rights and obligations of third-party obligors) by reason of such breach. However, nothing in this recommendation affects any obligation or liability of the party in breach of such an agreement for any damages arising as a result of the breach.

Right to payment

116. The law should provide that:

- (a) As between the assignor and the assignee, unless otherwise agreed and whether or not notification of the assignment has been sent:
 - (i) If payment in respect of the assigned receivable is made to the assignee, the assignee is entitled to retain the proceeds and tangible assets returned in respect of the assigned receivable;

³⁴For recommendations 114-116, see articles 12-14 of the United Nations Assignment Convention.

- (ii) If payment in respect of the assigned receivable is made to the assignor, the assignee is entitled to payment of the proceeds and also to tangible assets returned to the assignor in respect of the assigned receivable; and
 - (iii) If payment in respect of the assigned receivable is made to another person over whom the assignee has priority, the assignee is entitled to payment of the proceeds and also to tangible assets returned to such person in respect of the assigned receivable;
- (b) The assignee may not retain more than the value of its right in the receivable.

VII. Rights and obligations of third-party obligors

Purpose

The purpose of provisions on the rights and obligations of third-party obligors is to enhance the efficiency of secured transactions where the encumbered asset is a payment obligation or other performance owed by a third party to the grantor by:

- (a) Providing rules relating to rights and obligations of parties to the assignment of a receivable and the protection of the debtor of the receivable;
- (b) Providing rules to ensure the coherence of secured transactions law with other law relating to the rights and obligations arising under negotiable instruments and negotiable documents; and
- (c) Providing rules to ensure the coherence of the secured transactions regime with other law governing the rights and obligations of depositary banks, and of the guarantor/ issuer, confirmer or nominated person under an independent undertaking.

A. Rights and obligations of the debtor of the receivable³⁵

Protection of the debtor of the receivable

117. The law should provide that:

- (a) Except as otherwise provided in this law, an assignment does not, without the consent of the debtor of the receivable, affect the rights and obligations of the debtor of the receivable, including the payment terms contained in the original contract; and
- (b) A payment instruction may change the person, address or account to which the debtor of the receivable is required to make payment, but may not change:
 - (i) The currency of payment specified in the original contract; or
 - (ii) The State specified in the original contract in which payment is to be made to a State other than that in which the debtor of the receivable is located.

³⁵For recommendations 117-123, see articles 15-21 of the United Nations Assignment Convention.

Notification of the assignment

118. The law should provide that:

(a) Notification of the assignment or a payment instruction is effective when received by the debtor of the receivable if it is in a language that is reasonably expected to inform the debtor of the receivable about its contents. It is sufficient if notification of the assignment or a payment instruction is in the language of the original contract;

(b) Notification of the assignment or a payment instruction may relate to receivables arising after notification; and

(c) Notification of a subsequent assignment constitutes notification of all prior assignments.

Discharge of the debtor of the receivable by payment

119. The law should provide that:

(a) Until the debtor of the receivable receives notification of the assignment, it is entitled to be discharged by paying in accordance with the original contract;

(b) After the debtor of the receivable receives notification of the assignment, subject to subparagraphs (c)-(h) of this recommendation, it is discharged only by paying the assignee or, if otherwise instructed in the notification of the assignment or subsequently by the assignee in a writing received by the debtor of the receivable, in accordance with such payment instruction;

(c) If the debtor of the receivable receives more than one payment instruction relating to a single assignment of the same receivable by the same assignor, it is discharged by paying in accordance with the last payment instruction received from the assignee before payment;

(d) If the debtor of the receivable receives notification of more than one assignment of the same receivable made by the same assignor, it is discharged by paying in accordance with the first notification received;

(e) If the debtor of the receivable receives notification of one or more subsequent assignments, it is discharged by paying in accordance with the notification of the last of such subsequent assignments;

(f) If the debtor of the receivable receives notification of the assignment of a part of or an undivided interest in one or more receivables, it is discharged by paying in accordance with the notification or in accordance with this recommendation as if the debtor of the receivable had not received the notification. If the debtor of the receivable pays in accordance with the notification, it is discharged only to the extent of the part or undivided interest paid;

(g) If the debtor of the receivable receives notification of the assignment from the assignee, it is entitled to request the assignee to provide within a reasonable period of time adequate proof that the assignment from the initial assignor to the initial assignee and any intermediate assignment have been made and, unless the assignee does so, the debtor of the receivable is discharged by paying in accordance with this recommendation as if the notification from the assignee had not been received. Adequate proof of an assignment

includes but is not limited to any writing emanating from the assignor and indicating that the assignment has taken place; and

(h) This recommendation does not affect any other ground on which payment by the debtor of the receivable to the person entitled to payment, to a competent judicial or other authority, or to a public deposit fund discharges the debtor of the receivable.

Defences and rights of set-off of the debtor of the receivable

120. The law should provide that:

(a) In a claim by the assignee against the debtor of the receivable for payment of the assigned receivable, the debtor of the receivable may raise against the assignee all defences and rights of set-off arising from the original contract, or any other contract that was part of the same transaction, of which the debtor of the receivable could avail itself as if the assignment had not been made and such claim were made by the assignor;

(b) The debtor of the receivable may raise against the assignee any other right of set-off, provided that it was available to the debtor of the receivable at the time notification of the assignment was received by the debtor of the receivable; and

(c) Notwithstanding subparagraphs (a) and (b) of this recommendation, defences and rights of set-off that the debtor of the receivable may raise pursuant to recommendation 24, subparagraph (b), or recommendation 25, subparagraph (e) (chapter II on the creation of a security right), against the assignor for breach of an agreement limiting in any way the assignor's right to make the assignment are not available to the debtor of the receivable against the assignee.

Agreement not to raise defences or rights of set-off

121. The law should provide that:

(a) The debtor of the receivable may agree with the assignor in a writing signed by the debtor of the receivable not to raise against the assignee the defences and rights of set-off that it could raise pursuant to recommendation 120. Such an agreement precludes the debtor of the receivable from raising against the assignee those defences and rights of set-off;

(b) The debtor of the receivable may not waive defences:

- (i) Arising from fraudulent acts on the part of the assignee; or
- (ii) Based on the incapacity of the debtor of the receivable; and

(c) Such an agreement may be modified only by an agreement in a writing signed by the debtor of the receivable. The effect of such a modification as against the assignee is determined by recommendation 122, subparagraph (b).

Modification of the original contract

122. The law should provide that:

(a) An agreement concluded before notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is effective as against the assignee, and the assignee acquires corresponding rights;

(b) An agreement concluded after notification of the assignment between the assignor and the debtor of the receivable that affects the assignee's rights is ineffective as against the assignee unless:

(i) The assignee consents to it; or

(ii) The receivable is not fully earned by performance and either the modification is provided for in the original contract or, in the context of the original contract, a reasonable assignee would consent to the modification; and

(c) Subparagraphs (a) and (b) of this recommendation do not affect any right of the assignor or the assignee arising from breach of an agreement between them.

Recovery of payments

123. The law should provide that failure of the assignor to perform the original contract does not entitle the debtor of the receivable to recover from the assignee a sum paid by the debtor of the receivable to the assignor or the assignee.

B. Rights and obligations of the obligor under a negotiable instrument

124. The law should provide that a secured creditor's rights under a negotiable instrument are, as against a person obligated on the negotiable instrument, subject to the law governing negotiable instruments.

C. Rights and obligations of a depositary bank

125. The law should provide that:

(a) The creation of a security right in a right to payment of funds credited to a bank account does not affect the rights and obligations of a depositary bank without its consent; and

(b) Any rights of set-off that a depositary bank may have under other law are not impaired by reason of any security right that the bank may have in a right to payment of funds credited to a bank account.

126. The law should provide that a depositary bank is not obligated:

(a) To pay any person other than a person that has control with respect to funds credited to a bank account;

(b) To respond to requests for information about whether a control agreement or a security right in its own favour exists and whether the grantor retains the right to dispose of the funds credited in the account; or

(c) To enter into a control agreement.

D. Rights and obligations of the guarantor/issuer, confirmer or nominated person of an independent undertaking

127. The law should provide that:

(a) A secured creditor's right in the right to receive the proceeds under an independent undertaking is subject to the rights, under the law and practice governing independent undertakings, of a guarantor/issuer, confirmer or nominated person and of any other beneficiary named in the undertaking or to whom a transfer of the right to draw has been effected;

(b) The rights of a transferee of an independent undertaking are not affected by a security right in the right to receive the proceeds under the independent undertaking created by the transferor or any prior transferor; and

(c) The independent rights of a guarantor/issuer, confirmer, nominated person or transferee of an independent undertaking are not adversely affected by reason of any security right it may have in the right to receive proceeds under the independent undertaking.

128. The law should provide that a guarantor/issuer, confirmer or nominated person is not obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the right to receive the proceeds under an independent undertaking.

129. The law should provide that, if a secured creditor obtains control by becoming an acknowledged assignee of the proceeds under an independent undertaking, the secured creditor has the right to enforce the acknowledgement against the guarantor/issuer, confirmer or nominated person that made the acknowledgement.

E. Rights and obligations of the issuer of a negotiable document

130. The law should provide that a secured creditor's rights under a negotiable document are, as against the issuer or any other person obligated on the negotiable document, subject to the law governing negotiable documents.

VIII. Enforcement of a security right

Purpose

The purpose of provisions on enforcement of security rights is to provide:

(a) Clear, simple and efficient methods for the enforcement of security rights after debtor default;

(b) Methods designed to maximize the net amount realized from the encumbered assets, for the benefit of the grantor, the debtor or any other person that owes payment of the secured obligation, the secured creditor and other creditors with a right in the encumbered assets; and

(c) Expeditious judicial and, subject to appropriate safeguards, non-judicial methods for the secured creditor to exercise its rights.

A. General recommendations

General standard of conduct in the context of enforcement

131. The law should provide that a person must enforce its rights and perform its obligations under the provisions on enforcement in good faith and in a commercially reasonable manner.

Limitations on party autonomy

132. The law should provide that the general standard of conduct provided in recommendation 131 cannot be waived unilaterally or varied by agreement at any time.

133. The law should provide that, subject to recommendation 132, the grantor and any other person that owes payment or other performance of the secured obligation may waive unilaterally or vary by agreement any of its rights under the provisions on enforcement, but only after default.

134. The law should provide that, subject to recommendation 132, the secured creditor may waive unilaterally or vary by agreement any of its rights under the provisions on enforcement.

135. The law should provide that a variation of rights by agreement may not adversely affect the rights of any person not a party to the agreement. A person challenging the effectiveness of the agreement on the ground that it is inconsistent with recommendation 132, 133 or 134 has the burden of proof.

Liability

136. The law should provide that, if a person fails to comply with its obligations under the provisions on enforcement, it is liable for damages caused by such failure.

Judicial or other relief for non-compliance

137. The law should provide that the debtor, the grantor or any other interested person (for example, a secured creditor with a lower priority ranking than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered assets) is entitled at any time to apply to a court or other authority for relief from the secured creditor's failure to comply with its obligations under the provisions on enforcement.

Expeditious judicial proceedings

138. The law should provide for expeditious proceedings to accommodate situations where the secured creditor, the grantor or any other person that owes performance of the secured obligation, or claims to have a right in an encumbered asset, applies to a court or other authority with respect to the exercise of post-default rights.

Post-default rights of the grantor

139. The law should provide that, after default, the grantor is entitled to exercise one or more of the following rights:

(a) Pay in full the secured obligation and obtain a release from the security right of all encumbered assets, as provided in recommendation 140;

(b) Apply to a court or other authority for relief if the secured creditor is not complying with its obligations under the provisions of this law, as provided in recommendation 137;

(c) Propose to the secured creditor, or reject the proposal of the secured creditor, that the secured creditor acquire an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 158 and 159; and

(d) Exercise any other right provided in the security agreement or any law.

Extinction of the security right after full satisfaction of the secured obligation

140. The law should provide that the debtor, the grantor or any other interested person (for example, a secured creditor whose security right has lower priority than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered asset) is entitled to satisfy the secured obligation in full, including payment of the costs of enforcement up to the time of full satisfaction. This right may be exercised until the earlier of the disposition, acquisition or collection of an encumbered asset by the secured creditor or the conclusion of an agreement by the secured creditor to dispose of the encumbered asset. If all commitments to extend credit have terminated, full satisfaction of the secured obligation extinguishes the security right in all encumbered assets, subject to any rights of subrogation in favour of the person satisfying the secured obligation.

Post-default rights of the secured creditor

141. The law should provide that, after default, the secured creditor is entitled to exercise one or more of the following rights with respect to an encumbered asset:

(a) Obtain possession of a tangible encumbered asset, as provided in recommendations 146 and 147;

(b) Sell or otherwise dispose of, lease or license an encumbered asset, as provided in recommendations 148-155;

(c) Propose that the secured creditor acquire an encumbered asset in total or partial satisfaction of the secured obligation, as provided in recommendations 156-158;

(d) Enforce its security right in an attachment, as provided in recommendations 165 and 166;

(e) Collect on or otherwise enforce a security right in an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or right to receive the proceeds under an independent undertaking, as provided in recommendations 167-176;

(f) Enforce rights under a negotiable document, as provided in recommendation 177; and

(g) Exercise any other right provided in the security agreement (except to the extent inconsistent with the provisions of this law) or any law.

Judicial and extrajudicial methods of exercising post-default rights

142. The law should provide that, after default, the secured creditor may exercise its rights provided in recommendation 141 either by applying to a court or other authority, or without application to a court or other authority. Extrajudicial exercise of the secured creditor's rights is subject to the general standard of conduct provided in recommendation 131 and the requirements provided in recommendations 147-155 with respect to extrajudicial obtaining of possession and disposition of an encumbered asset.

Cumulative post-default rights

143. The law should provide that the exercise of one post-default right does not prevent the exercise of another right, except to the extent that the exercise of one right has made the exercise of another right impossible.

Post-default rights with respect to the secured obligation

144. The law should provide that the exercise of a post-default right with respect to an encumbered asset does not prevent the exercise of a post-default right with respect to the obligation secured by that asset, and vice versa.

Right of higher-ranking secured creditor to take over enforcement

145. The law should provide that, if a secured creditor has commenced enforcement by taking any of the actions described in the provisions on enforcement or a judgement creditor has taken the steps referred to in recommendation 84 (chapter V on the priority of a security right), a secured creditor whose security right has priority as against that of the enforcing secured creditor or the enforcing judgement creditor is entitled to take over the enforcement process at any time before the earlier of the disposition, acquisition or collection of an encumbered asset or the conclusion of an agreement by the enforcing secured creditor to dispose of the encumbered asset. The right to take over enforcement includes the right to enforce by any method available under the recommendations in this chapter.

Secured creditor's right to possession of an encumbered asset

146. The law should provide that after default the secured creditor is entitled to possession of a tangible encumbered asset.

Extrajudicial obtaining of possession of an encumbered asset

147. The law should provide that the secured creditor may elect to obtain possession of a tangible encumbered asset without applying to a court or other authority only if:

(a) The grantor has consented in the security agreement to the secured creditor obtaining possession without applying to a court or other authority;

(b) The secured creditor has given the grantor and any person in possession of the encumbered asset notice of default and of the secured creditor's intent to obtain possession without applying to a court or other authority; and

(c) At the time the secured creditor seeks to obtain possession of the encumbered asset the grantor and any person in possession of the encumbered asset does not object.

Extrajudicial disposition of an encumbered asset

148. The law should provide that, after default, a secured creditor is entitled, without applying to a court or other authority, to sell or otherwise dispose of, lease or license an encumbered asset to the extent of the grantor's rights in the encumbered asset. Subject to the standard of conduct provided in recommendation 131, a secured creditor that elects to exercise this right may select the method, manner, time, place and other aspects of the disposition, lease or licence.

Advance notice of extrajudicial disposition of an encumbered asset

149. The law should provide that, after default, the secured creditor must give notice of its intention to sell or otherwise dispose of, lease or licence an encumbered asset without applying to a court or other authority. The notice need not be given if the encumbered asset is perishable, may decline in value speedily or is of a kind sold on a recognized market.

150. The law should provide rules ensuring that the notice referred to in recommendation 149 can be given in an efficient, timely and reliable way so as to protect the grantor or other interested parties, while, at the same time, avoiding having a negative effect on the secured creditor's remedies and the potential net realization value of the encumbered assets.

151. With respect to the notice referred to in recommendation 149, the law should:

(a) Provide that the notice must be given to:

(i) The grantor, the debtor and any other person that owes performance of the secured obligation;

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days before the sending of the notice by the secured creditor to the grantor, notifies in writing the secured creditor of those rights;

(iii) Any other secured creditor that, more than [a short period of time to be specified] days before the notice is sent to the grantor, registers a notice with

respect to a security right in the encumbered asset that is indexed under the identifier of the grantor; and

(iv) Any other secured creditor that was in possession of the encumbered asset at the time when the enforcing secured creditor took possession of the asset;

(b) State the manner in which the notice must be given, its timing and its minimum contents, including whether the notice must contain an accounting of the amount then owed and a reference to the right of the debtor or the grantor to obtain the release of the encumbered assets from the security right as provided in recommendation 140; and

(c) Provide that the notice must be in a language that is reasonably expected to inform its recipients about its contents. It is sufficient if the notice to the grantor is in the language of the security agreement being enforced.

Distribution of proceeds of disposition of an encumbered asset

152. The law should provide that, in the case of extrajudicial disposition of an encumbered asset, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. Except as provided in recommendation 153, the enforcing secured creditor must pay any surplus remaining to any subordinate competing claimant that, prior to any distribution of the surplus, notified the enforcing secured creditor of the subordinate competing claimant's claim, to the extent of the amount of that claim. The balance remaining, if any, must be remitted to the grantor.

153. The law should also provide that, in the case of extrajudicial disposition of an encumbered asset, whether or not there is any dispute as to the entitlement of any competing claimant or as to the priority of payment, the enforcing secured creditor may, in accordance with generally applicable procedural rules, pay the surplus to a competent judicial or other authority or to a public deposit fund for distribution. The surplus should be distributed in accordance with the provisions of this law on priority.

154. The law should provide that distribution of the proceeds realized by a judicial disposition or other officially administered enforcement process is to be made pursuant to the general rules of the State governing execution proceedings, but in accordance with the provisions of this law on priority.

155. The law should provide that the debtor and any other person that owes payment of the secured obligation remain liable for any shortfall owing after application of the net proceeds of enforcement to the secured obligation.

Acquisition of an encumbered asset in satisfaction of the secured obligation

156. The law should provide that, after default, the secured creditor may propose in writing to acquire one or more of the encumbered assets in total or partial satisfaction of the secured obligation.

157. With respect to the proposal referred to in recommendation 156, the law should:

(a) Provide that the proposal must be sent to:

(i) The grantor, the debtor and any other person that owes payment or other performance of the secured obligation (for example, a guarantor);

(ii) Any person with rights in the encumbered asset that, more than [to be specified] days before the proposal is sent by the secured creditor to the grantor, has notified in writing the secured creditor of those rights;

(iii) Any other secured creditor that, more than [a short period of time to be specified] days before the proposal is sent by the secured creditor to the grantor, registered a notice with respect to a security right in the encumbered asset indexed under the identifier of the grantor; and

(iv) Any other secured creditor that was in possession of the encumbered asset at the time the secured creditor took possession; and

(b) Provide that the proposal must specify the amount owed as of the date the proposal is sent and the amount of the obligation that is proposed to be satisfied by acquiring the encumbered asset.

158. The law should provide that the secured creditor may acquire the encumbered asset, as provided in recommendation 156, unless the secured creditor receives an objection in writing from any person entitled to receive a proposal under recommendation 157 within [a short period of time to be specified] days after the proposal is sent. In the case of a proposal for the acquisition of the encumbered asset in partial satisfaction of the secured obligation, affirmative consent by each addressee of the proposal is necessary.

159. The law should provide that the grantor may make a proposal such as that referred to in recommendation 156 and if the secured creditor accepts it, the secured creditor must proceed as provided in recommendations 157 and 158.

Rights acquired through judicial disposition

160. The law should provide that, if a secured creditor disposes of an encumbered asset through a judicial or other officially administered process, the rights acquired by the transferee are determined by the general rules of the State governing execution proceedings.

Rights acquired through extrajudicial disposition

161. The law should provide that, if a secured creditor sells or otherwise disposes of an encumbered asset without applying to a court or other authority, in accordance with the law, a person that acquires the grantor's right in the asset takes the asset subject to rights that have priority as against the security right of the enforcing secured creditor, but free of rights of the enforcing secured creditor and any competing claimant whose right has a lower priority than that of the enforcing secured creditor. The same rule applies to rights in an encumbered asset acquired by a secured creditor that has acquired the asset in total or partial satisfaction of the secured obligation.

162. The law should provide that, if a secured creditor leases or licenses an encumbered asset without applying to a court or other authority, in accordance with the law, a lessee or licensee is entitled to the benefit of the lease or licence during its term, except as against rights that have priority over the right of the enforcing secured creditor.

163. The law should provide that, if the secured creditor sells or otherwise disposes of, leases or licenses the encumbered asset not in accordance with the recommendations in this chapter, a good faith acquirer, lessee or licensee of the encumbered asset acquires the rights or benefits described in recommendations 161 and 162.

Intersection of movable and immovable property enforcement regimes

164. The law should provide that:

(a) The secured creditor may elect to enforce a security right in an attachment to immovable property in accordance with the recommendations in this chapter or the law governing enforcement of encumbrances on immovable property; and

(b) If an obligation is secured by both a movable asset and immovable property of a grantor, the secured creditor may elect to enforce:

(i) The security right in the movable asset under the provisions on enforcement of a security right in a movable asset and the encumbrance on the immovable property under the law governing enforcement of encumbrances on immovable property; or

(ii) Both rights under the law governing enforcement of encumbrances on immovable property.

Enforcement of a security right in an attachment

165. The law should provide that a secured creditor with a security right in an attachment to immovable property is entitled to enforce its security right only if it has priority as against competing rights in the immovable property. A creditor with a competing right in immovable property that has lower priority is entitled to pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the immovable property caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.

166. The law should provide that a secured creditor with a security right in an attachment to a movable asset is entitled to enforce its security right in the attachment. A creditor with higher priority is entitled to take control of the enforcement process, as provided in recommendation 145. A creditor with lower priority may pay off the obligation secured by the security right of the enforcing secured creditor in the attachment. The enforcing secured creditor is liable for any damage to the movable asset caused by the act of removal other than any diminution in its value attributable solely to the absence of the attachment.

B. Asset-specific recommendations

Application of the chapter on enforcement to an outright transfer of a receivable

167. The law should provide that the recommendations in this chapter do not apply to the collection or other enforcement of a receivable assigned by an outright transfer with the exception of:

- (a) Recommendations 131 and 132 in the case of an outright transfer with recourse; and
- (b) Recommendations 168 and 169.

Enforcement of a security right in a receivable

168. The law should provide that, in the case of a receivable assigned by an outright transfer, subject to recommendations 117-123 (chapter VII on the rights and obligations of third-party obligors), the assignee has the right to collect or otherwise enforce the receivable. In the case of a receivable assigned otherwise than by an outright transfer, the assignee is entitled, subject to recommendations 117-123, to collect or otherwise enforce the receivable after default, or before default with the agreement of the assignor.

169. The law should provide that the assignee's right to collect or otherwise enforce a receivable includes the right to collect or otherwise enforce any personal or property right that secures payment of the receivable.

Enforcement of a security right in a negotiable instrument

170. The law should provide that, after default or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 124 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce a negotiable instrument that is an encumbered asset against a person obligated on that instrument.

171. The law should provide that the secured creditor's right to collect or otherwise enforce a negotiable instrument includes the right to collect or otherwise enforce any personal or property right that secures payment of the negotiable instrument.

Distribution of proceeds of disposition where the encumbered asset is a receivable, negotiable instrument or other claim

172. The law should provide that, in the case of collection or other enforcement of a receivable or negotiable instrument, or enforcement of a claim, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligation. The enforcing secured creditor must pay any surplus remaining to any subordinate competing claimant that, prior to any distribution of the surplus, notified the enforcing secured creditor of the subordinate competing claimant's claim, to the extent of the amount of that claim. The balance remaining, if any, must be remitted to the grantor.

Enforcement of a security right in a right to payment of funds credited to a bank account

173. The law should provide that, after default or before default with the agreement of the grantor, a secured creditor with a security right in a right to payment of funds credited to a bank account is entitled, subject to recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce its right to payment of the funds.

174. The law should provide that a secured creditor that has control is entitled, subject to recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors), to enforce its security right without having to apply to a court or other authority.

175. The law should provide that a secured creditor that does not have control is entitled, subject to recommendations 125 and 126 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce the security right in the right to payment of funds credited to a bank account against the depositary bank only pursuant to a court order, unless the depositary bank agrees otherwise.

Enforcement of a security right in a right to receive the proceeds under an independent undertaking

176. The law should provide that, after default or before default with the agreement of the grantor, a secured creditor with a security right in a right to receive the proceeds under an independent undertaking is entitled, subject to recommendations 127-129 (chapter VII on the rights and obligations of third-party obligors), to collect or otherwise enforce its right in the right to receive the proceeds under the independent undertaking.

Enforcement of a security right in a negotiable document or a tangible asset covered by a negotiable document

177. The law should provide that, after default or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation 130 (chapter VII on the rights and obligations of third-party obligors), to enforce a security right in a negotiable document or a tangible asset covered by the document.

IX. Acquisition financing

Option A: Unitary approach*

Purpose

The purpose of provisions on acquisition security rights is:

(a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit, especially for small and medium-sized businesses;

- (b) To provide for equal treatment of all providers of acquisition financing; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing.

An acquisition security right as a security right

178. The law should provide that an acquisition security right is a security right. Thus, all the recommendations governing security rights, including those on creation, third-party effectiveness (except as provided in recommendation 179), registration, enforcement and the law applicable to a security right, apply to acquisition security rights. The recommendations on priority also apply (except as provided in recommendations 180-185).

Third-party effectiveness and priority of an acquisition security right in consumer goods

179. The law should provide that an acquisition security right in consumer goods is effective against third parties upon its creation and, except as provided in recommendation 181, has priority as against a competing non-acquisition security right created by the grantor.

Priority of an acquisition security right in a tangible asset

180. The law should provide that, except as provided in recommendation 181:

Alternative A**

(a) An acquisition security right in a tangible asset other than inventory or consumer goods has priority as against a competing non-acquisition security right created by the grantor (even if a notice with respect to that security right was registered in the general security rights registry before registration of a notice with respect to the acquisition security right), provided that:

- (i) The acquisition secured creditor retains possession of the asset; or
- (ii) A notice with respect to the acquisition security right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] after the grantor obtains possession of the asset;

(b) An acquisition security right in inventory has priority as against a competing non-acquisition security right created by the grantor (even if that security right became effective against third parties before the acquisition security right became effective against third parties), provided that:

- (i) The acquisition secured creditor retains possession of the inventory;
- or

*A State may adopt option A (unitary approach), that is, recommendations 178-186, or option B (non-unitary approach), that is, recommendations 187-202. The recommendations outside this chapter are generally applicable to acquisition financing except to the extent modified by the recommendations in this chapter.

**A State may adopt alternative A or alternative B of recommendation 180.

- (ii) Before delivery of the inventory to the grantor:
 - a. A notice with respect to the acquisition security right is registered in the general security rights registry; and
 - b. A secured creditor with an earlier-registered non-acquisition security right created by the grantor in inventory of the same kind is notified by the acquisition secured creditor that it has or intends to acquire an acquisition security right. The notice must describe the inventory sufficiently to enable the non-acquisition secured creditor to identify the inventory that is the object of the acquisition security right;

(c) A notice, sent pursuant to subparagraph (b) (ii) b of this recommendation, may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction. The notice is sufficient only for security rights in tangible assets of which the grantor obtains possession within a period of [a period of time, such as five years, to be specified] after the notice is given.

Alternative B

An acquisition security right in a tangible asset other than consumer goods has priority as against a competing non-acquisition security right created by the grantor (even if a notice of that security right was registered in the general security rights registry before registration of a notice of the acquisition security right), provided that:

- (a) The acquisition secured creditor retains possession of the asset; or
- (b) A notice relating to the acquisition security right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] after the grantor obtains possession of the asset.

Priority of a security right registered in a specialized registry or noted on a title certificate

181. The law should provide that the priority of an acquisition security right under recommendation 179 or 180 does not override the priority of a security right or other right registered in a specialized registry or noted on a title certificate as provided in recommendations 77 and 78 (chapter V on the priority of a security right).

Priority between competing acquisition security rights

182. The law should provide that the priority between competing acquisition security rights is determined according to the general priority rules applicable to non-acquisition security rights, unless one of the acquisition security rights is an acquisition security right of a supplier that was made effective against third parties within the period specified in recommendation 180, in which case the supplier's acquisition security right has priority as against all competing acquisition security rights.

Priority of an acquisition security right as against the right of a judgement creditor

183. The law should provide that an acquisition security right that is made effective against third parties within the period specified in recommendation 180 has priority as against the rights of an unsecured creditor that would otherwise have priority as provided in recommendation 84 (chapter V on the priority of a security right).

Priority of an acquisition security right in an attachment to immovable property as against an earlier registered encumbrance on the immovable property

184. The law should provide that an acquisition security right in a tangible asset that becomes an attachment to immovable property has priority as against third parties with existing rights in the immovable property (other than an encumbrance securing a loan financing the construction of the immovable property), provided that notice of the acquisition security right is registered in the immovable property registry not later than [a short time period, such as 20-30 days, to be specified] days after the asset becomes an attachment.

Priority of an acquisition security right in proceeds of a tangible asset

185. The law should provide that:

Alternative A*

(a) An acquisition security right in proceeds of a tangible asset other than inventory or consumer goods has the same priority as the acquisition security right in that asset; and

(b) A security right in proceeds of inventory has the same priority as the acquisition security right in that inventory, except where the proceeds take the form of receivables, negotiable instruments, rights to payment of funds credited to a bank account or rights to receive the proceeds under an independent undertaking. However, this priority is conditional on the acquisition secured creditor notifying secured creditors that, before the proceeds arise, it registered a notice with respect to a security right in assets of the same kind as the proceeds.

Alternative B

If an acquisition security right in a tangible asset is effective against third parties, the security right in proceeds has the priority of a non-acquisition security right.

Acquisition security right as a security right in insolvency proceedings

186. The law should provide that, in the case of insolvency proceedings with respect to the debtor, the provisions that apply to security rights apply also to acquisition security rights.

*A State may adopt alternative A of recommendation 185, if it adopts alternative A of recommendation 180, or alternative B of recommendation 185, if it adopts alternative B of recommendation 180.

Option B: Non-unitary approach*

Purpose

The purpose of provisions on acquisition financing, including acquisition security rights, retention-of-title rights and financial lease rights, is:

- (a) To recognize the importance and facilitate the use of acquisition financing as a source of affordable credit especially for small and medium-sized businesses;
- (b) To provide for equal treatment of all providers of acquisition financing; and
- (c) To facilitate secured transactions in general by creating transparency with respect to acquisition financing.

Methods of acquisition financing

187. The law should provide that:

- (a) The regime of acquisition security rights in the context of the non-unitary approach is identical to that adopted in the context of the unitary approach;
- (b) All creditors, both suppliers and lenders, may acquire an acquisition security right in conformity with the regime governing acquisition security rights;
- (c) Acquisition financing based on retention-of-title rights and financial lease rights may be provided in accordance with recommendation 188; and
- (d) A lender may acquire the benefit of a retention-of-title right and a financial lease right through an assignment or subrogation.

Equivalence of a retention-of-title right and a financial lease right to an acquisition security right

188. The law should provide that the rules governing acquisition financing produce functionally equivalent economic results regardless of whether the creditor's right is a retention-of-title right, a financial lease right or an acquisition security right.

Effectiveness of a retention-of-title right and a financial lease right

189. The law should provide that a retention-of-title right or a financial lease right in a tangible asset is not effective unless the sale or lease agreement is concluded in or evidenced by a writing that, in conjunction with the course of conduct between the parties, indicates the seller's or the lessor's intent to retain ownership. The writing must exist not later than the time when the buyer or lessee obtains possession of the asset.

*A State may adopt option A (unitary approach), that is, recommendations 178-186, or option B (non-unitary approach), that is, recommendations 187-202.

Right of buyer or lessee to create a security right

190. The law should provide that a buyer or lessee may create a security right in a tangible asset that is the object of a retention-of-title right or a financial lease right. The maximum amount realizable under the security right is the asset's value in excess of the amount owing to the seller or financial lessor.

Third-party effectiveness of a retention-of-title right or financial lease right in consumer goods

191. The law should provide that a retention-of-title right or a financial lease right in consumer goods is effective against third parties upon conclusion of the sale or lease provided that the right is evidenced in accordance with recommendation 189.

Third-party effectiveness of a retention-of-title right or financial lease right in a tangible asset

192. The law should provide that:

Alternative A*

(a) A retention-of-title right or a financial lease right in a tangible asset other than inventory or consumer goods is effective against third parties only if:

- (i) The seller or lessor retains possession of the asset; or
- (ii) A notice relating to the right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] days after the buyer or lessee obtains possession of the asset;

(b) A retention-of-title right or a financial lease right in inventory is effective against third parties only if:

- (i) The seller or lessor retains possession of the inventory; or
- (ii) Before delivery of the inventory to the buyer or lessee:
 - a. A notice relating to the right is registered in the general security rights registry; and
 - b. A secured creditor with an earlier registered non-acquisition security right created by the buyer or lessee in inventory of the same kind is notified by the seller or lessor of its intention to claim a retention-of-title right or a financial lease right. The notice should describe the inventory sufficiently to enable the secured creditor to identify the inventory that is the object of the retention-of-title right or the financial lease right;

(c) A notice sent pursuant to subparagraph (b) (ii) b. of this recommendation may cover retention-of-title rights and financial lease rights under multiple transactions between the same parties without the need to identify each transaction. The notice is effective only for rights in tangible assets of which the buyer or lessee obtains

*A State may adopt alternative A or alternative B of recommendation 192.

possession within a period of [a period of time, such as five years, to be specified] years after the notice is given.

Alternative B

A retention-of-title right or financial lease right in a tangible asset other than consumer goods is effective against third parties only if:

(a) The seller or lessor retains possession of the asset; or

(b) A notice relating to the right is registered in the general security rights registry not later than [a short time period, such as 20 or 30 days, to be specified] days after the buyer or lessee obtains possession of the asset.

The rule in this recommendation applies also to an acquisition security right in a tangible asset other than consumer goods.

One registration sufficient

193. The law should provide that registration of a single notice in the general security rights registry is sufficient to achieve third-party effectiveness of a retention-of-title right or a financial lease right under multiple transactions between the same parties, whether concluded before or after the registration, which involve tangible assets that fall within the description contained in the notice. The provisions on the registry system apply, with appropriate modifications as to terminology, to the registration of a retention-of-title right and a financial lease right.

Effect of failure to achieve third-party effectiveness of a retention-of-title right or a financial lease right

194. The law should provide that, if a retention-of-title right or a financial lease right is not effective against third parties, ownership of the asset as against third parties passes to the buyer or lessee, and the seller or lessor has a security right in the asset subject to the recommendations applicable to security rights.

Third-party effectiveness of a retention-of-title right or financial lease right in an attachment to immovable property

195. The law should provide that a retention-of-title right or a financial lease right in a tangible asset that becomes an attachment to immovable property is effective against third parties with rights in the immovable property that are registered in the immovable property registry only if it is registered in the immovable property registry not later than [a short time period, such as 20-30 days, to be specified] days after the asset becomes an attachment.

196. The law should provide that, if a seller or lessor fails to register a notice of its retention-of-title right or financial lease right in a tangible asset that became an attachment to immovable property within the time period provided in recommendation 195, the

retention-of-title right of the seller or the financial lease right of the lessor is deemed to be a security right.

Existence of a security right in proceeds of a tangible asset subject to a retention-of-title right or financial lease right

197. The law should provide that a seller or lessor with a retention-of-title right or financial lease right in a tangible asset has a security right in proceeds of the asset.

Third-party effectiveness of a security right in proceeds of a tangible asset subject to a retention-of-title right or financial lease right

198. The law should provide that:

(a) A security right in proceeds referred to in recommendation 197 is effective against third parties only if the proceeds are described in a generic way in the registered notice by which the retention-of-title right or financial lease right was made effective against third parties or the proceeds consist of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account;

(b) If the proceeds are not described in a generic way in the registered notice or do not consist of the types of asset referred to in subparagraph (a) of this recommendation, the security right in the proceeds is effective against third parties for [a short period of time to be specified] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendation 32 or 34 (chapter III on the effectiveness of a security right against third parties) before the expiry of that time period.

Priority of a security right in proceeds of a tangible asset

199. The law should provide that:

Alternative A*

(a) If a retention-of-title right or financial lease right is effective against third parties, the security right in proceeds referred to in recommendation 197 has priority as against another security right in the same asset; and

(b) If a retention-of-title right or financial lease right is effective against third parties, the security right in proceeds of inventory referred to in recommendation 197 has the same priority as a retention-of-title or financial lease right in that inventory, except where the proceeds take the form of receivables, negotiable instruments, rights to payment of funds credited to a bank account and rights to receive the proceeds under an independent undertaking. However, this priority is conditional on the seller or lessor notifying secured creditors that have registered a notice with respect to a security right in assets of the same kind as the proceeds before the proceeds arise.

*A State may adopt alternative A of recommendation 199, if it adopts alternative A of recommendation 192, or alternative B of recommendation 199, if it adopts alternative B of recommendation 192.

Alternative B

If a retention-of-title right or financial lease right in a tangible asset is effective against third parties, the security right in proceeds referred to in recommendation 197 has the priority of a non-acquisition security right if the security right in the proceeds is effective against third parties as provided in recommendation 198. This rule applies also to the proceeds of a tangible asset subject to an acquisition security right.

Enforcement of a retention-of-title right or a financial lease right

200. The law should provide that:

(a) Rules for the post-default enforcement of a retention-of-title right or a financial lease right in a tangible asset should deal with:

- (i) The manner in which the seller or lessor may obtain possession of the asset;
- (ii) Whether the seller or lessor is required to dispose of the asset and, if so, how;
- (iii) Whether the seller or lessor may retain any surplus; and
- (iv) Whether the seller or lessor has a claim for any deficiency against the buyer or lessee;

(b) The regime that applies to the post-default enforcement of a security right applies to the post-default enforcement of a retention-of-title right or a financial lease right except to the extent necessary to preserve the coherence of the regime applicable to sale and lease.

Law applicable to a retention-of-title right or a financial lease right

201. The law should provide that the conflict-of-laws provisions that apply to security rights apply also to retention-of-title rights and financial lease rights.

Retention-of-title right or financial lease right in insolvency proceedings

202. The law should provide that, in the case of insolvency proceedings with respect to the debtor,

Alternative A*

the provisions that apply to security rights apply also to retention-of-title rights and financial lease rights.

Alternative B

the provisions of the law of the enacting State that apply to ownership rights of third parties apply also to retention-of-title rights and financial lease rights.

*A State may adopt alternative A or alternative B of recommendation 202.

X. Conflict of laws*

Purpose

The purpose of conflict-of-laws provisions is to determine the law applicable to: the creation, third-party effectiveness and priority of a security right; and the pre- and post-default rights and obligations of the grantor, secured creditor and third parties.³⁶

A. General recommendations

Law applicable to a security right in a tangible asset

203. The law³⁷ should provide that, except as provided in recommendations 204-207 and 211, the law applicable to the creation, effectiveness against third parties and priority of a security right in a tangible asset is the law of the State in which the asset is located.

204. The law should provide that the law applicable to the issues mentioned in recommendation 203 with respect to a security right in a tangible asset of a type ordinarily used in more than one State is the law of the State in which the grantor is located.

205. The law should provide that, if a security right in a tangible asset is subject to registration in a specialized registry or notation on a title certificate, the law applicable to the issues mentioned in recommendation 203 is the law of the State under whose authority the registry is maintained or the title certificate is issued.

206. The law should provide that the law applicable to the priority of a security right in a tangible asset made effective against third parties by possession of a negotiable document as against a competing security right made effective against third parties by another method is the law of the State in which the document is located.

Law applicable to a security right in a tangible asset in transit or to be exported

207. The law should provide that a security right in a tangible asset (other than a negotiable instrument or a negotiable document) in transit or to be exported from the State in which it is located at the time of the creation of the security right may be created and made effective against third parties under the law of the State of the location of the asset at the time of creation as provided in recommendation 203 or, provided that the asset reaches that State within [a short period of time to be specified] days after the time of creation of the security right, under the law of the State of its ultimate destination.

*The recommendations on conflicts of laws were prepared in close cooperation with the Permanent Bureau of the Hague Conference on Private International Law.

³⁶Conflict-of-laws issues relating to acquisition financing are addressed in chapter IX. Conflict-of-laws issues relating to insolvency are addressed in this chapter and in chapter XII.

³⁷“Law” in this chapter means the secured transactions law or other law in which a State may include conflict-of-laws provisions.

Law applicable to a security right in an intangible asset

208. The law should provide that the law applicable to the creation, effectiveness against third parties and priority of a security right in an intangible asset is the law of the State in which the grantor is located.

Law applicable to a security right in receivables arising from a sale, lease or transaction secured by a security agreement relating to immovable property

209. The law should provide that the law applicable to the creation, effectiveness against third parties and priority of a security right in a receivable arising from a sale, lease or transaction secured by a security agreement relating to immovable property is the law of the State in which the assignor is located. However, the law applicable to a priority conflict involving the right of a competing claimant that is registered in an immovable property registry is the law of the State under whose authority the registry is maintained. The rule in the preceding sentence applies only if registration is relevant under that law to the priority of a security right in the receivable.

Law applicable to a security right in a right to payment of funds credited to a bank account

210. The law should provide that the law applicable to the creation, effectiveness against third parties, priority and enforcement of a security right in a right to payment of funds credited to a bank account, as well as rights and duties of the depositary bank with respect to the security right, is

Alternative A*

the law of the State in which the bank that maintains the bank account has its place of business. If the bank has places of business in more than one State, reference should be made to the place where the branch maintaining the account is located.

Alternative B

the law of the State expressly stated in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. However, the law of the State determined pursuant to the preceding sentence applies only if the depositary bank has, at the time of the conclusion of the account agreement, an office in that State that is engaged in the regular activity of maintaining bank accounts. If the applicable law is not determined pursuant to the preceding two sentences, the applicable law is to be determined pursuant to default rules based on article 5 of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.³⁸

This recommendation is subject to the exception provided in recommendation 211.

*A State may adopt alternative A or alternative B of recommendation 210.

³⁸A State that adopts alternative B of recommendation 210 has to also adopt recommendations 226 and 227.

Law applicable to the third-party effectiveness of a security right in specified types of asset by registration

211. The law should provide that, if the State in which the grantor is located recognizes registration as a method of achieving effectiveness against third parties of a security right in a negotiable instrument or a right to payment of funds credited to a bank account, the law of the State in which the grantor is located is the law applicable to the issue of whether effectiveness against third parties has been achieved by registration under the laws of that State.

Law applicable to a security right in the right to receive the proceeds under an independent undertaking

212. The law should provide that the law of the State specified in an independent undertaking of a guarantor/issuer, confirmer or nominated person is the law applicable to:

(a) The rights and duties of the guarantor/issuer, confirmer or nominated person that has received a request for an acknowledgement or that has or may pay or otherwise give value under an independent undertaking;

(b) The right to enforce a security right in the right to receive the proceeds under the independent undertaking against the guarantor/issuer, confirmer or nominated person; and

(c) Except as provided in recommendation 213, the effectiveness against third parties and priority of a security right in the right to receive the proceeds under the independent undertaking.

213. The law should provide that, if the applicable law is not specified in the independent undertaking of the guarantor/issuer or confirmer, the law applicable to the issues referred to in recommendation 212 is the law of the State of the location of the branch or office of the guarantor/issuer or confirmer indicated in the independent undertaking. However, in the case of a nominated person, the applicable law is the law of the State of the location of the nominated person's branch or office that pays or otherwise gives value under the independent undertaking.

214. The law should provide that the law applicable to the creation and effectiveness against third parties of a security right in a receivable, negotiable instrument or other claim, the payment or other performance of which is secured by an independent undertaking, is also the law applicable to the issue of whether a security right in the right to receive the proceeds under the independent undertaking is created and made effective against third parties automatically as contemplated in recommendations 25 (chapter II on the creation of a security right) and 48 (chapter III on the effectiveness of a security right against third parties).

Law applicable to a security right in proceeds

215. The law should provide that:

(a) The law applicable to the creation of a security right in proceeds is the law applicable to the creation of the security right in the original encumbered asset from which the proceeds arose; and

(b) The law applicable to the effectiveness against third parties and priority of a security right in proceeds is the law applicable to the third-party effectiveness and priority of a security right in an asset of the same kind as the proceeds.

Law applicable to the rights and obligations of the grantor and the secured creditor

216. The law should provide that the law applicable to the mutual rights and obligations of the grantor and the secured creditor arising from their security agreement is the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement.

Law applicable to the rights and obligations of third-party obligors and secured creditors

217. The law should provide that the law applicable to a receivable, negotiable instrument or negotiable document also is the law applicable to:

(a) The relationship between the debtor of the receivable and the assignee of the receivable, and the relationship between an obligor under a negotiable instrument and the holder of a security right in the instrument;

(b) The conditions under which an assignment of the receivable, a security right in the negotiable instrument or a security right in the negotiable document may be invoked against the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document (including whether an anti-assignment agreement may be asserted by the debtor of the receivable, the obligor or the issuer); and

(c) Whether the obligations of the debtor of the receivable, the obligor on the negotiable instrument or the issuer of the negotiable document have been discharged.

Law applicable to enforcement of a security right

218. The law should provide that, subject to recommendation 223, the law applicable to issues relating to the enforcement of a security right:

(a) In a tangible asset is the law of the State where enforcement takes place; and

(b) In an intangible asset is the law applicable to the priority of the security right.

Meaning of “location” of the grantor

219. The law should provide that, for the purposes of the conflict-of-laws provisions, the grantor is located in the State in which it has its place of business. If the grantor has a place of business in more than one State, the grantor’s place of business is that place where the central administration of the grantor is exercised. If the grantor does not have a place of business, reference is to be made to the habitual residence of the grantor.

Relevant time for determining location

220. The law should provide that:

(a) Except as provided in subparagraph (b) of this recommendation, references to the location of the assets or of the grantor in the conflict-of-laws provisions refer, for creation issues, to the location at the time of the putative creation of the security right and, for third-party effectiveness and priority issues, to the location at the time the issue arises;

(b) If the rights of all competing claimants in an encumbered asset were created and made effective against third parties before a change in location of the asset or the grantor, references in the conflict-of-laws provisions to the location of the asset or of the grantor refer, with respect to third-party effectiveness and priority issues, to the location prior to the change in location.

Exclusion of renvoi

221. The law should provide that a reference in the conflict-of-laws provisions to “the law” of another State as the law applicable to an issue refers to the law in force in that State other than its conflict-of-laws provisions.

Public policy and internationally mandatory rules

222. The law should provide that:

(a) The application of the law determined under the conflict-of-laws provisions may be refused only if the effects of its application would be manifestly contrary to the public policy of the forum;

(b) The conflict-of-laws provisions do not prevent the application of those provisions of the law of the forum which, irrespective of conflict-of-laws provisions, must be applied even to international situations; and

(c) Subparagraphs (a) and (b) of this recommendation do not permit the application of the provisions of the law of the forum to the third-party effectiveness and priority of a security right.

Impact of commencement of insolvency proceedings on the law applicable to security rights

223. The law should provide that the commencement of insolvency proceedings does not displace the conflict-of-laws provisions that determine the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right (and, in the context of the non-unitary approach, a retention-of-title right and financial lease right). However, this provision should be subject to the effects on such issues of the application of the insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) to issues such as avoidance, treatment of secured creditors, ranking of claims or distribution of proceeds.³⁹

³⁹See recommendation 31 of the UNCITRAL Insolvency Guide.

B. Special recommendations when the applicable law is the law of a multi-unit State

224. The law should provide that, in situations in which the law applicable to an issue is the law of a multi-unit State subject to recommendation 225, references to the law of a multi-unit State are to the law of the relevant territorial unit (as determined on the basis of the location of the grantor or of an encumbered asset or otherwise under the conflict-of-laws provisions) and, to the extent applicable in that unit, to the law of the multi-unit State itself.

225. The law should provide that if, under its conflict-of-laws provisions, the applicable law is that of a multi-unit State or one of its territorial units, the internal conflict-of-laws provisions in force in the multi-unit State or territorial unit determine whether the substantive provisions of law of the multi-unit State or of a particular territorial unit of the multi-unit State apply.

226. The law should provide that, if the account holder and the depositary bank have chosen the law of a specified territorial unit of a multi-unit State as the law applicable to the account agreement:

(a) The references to “State” in the first sentence of recommendation 210 (alternative B) are to the territorial unit;

(b) The references to “that State” in the second sentence of recommendation 210 (alternative B) are to the multi-unit State itself.

227. The law should provide that the law of a territorial unit is the applicable law if:

(a) Under recommendations 210 (alternative B) and 226, the designated law is that of a territorial unit of a multi-unit State;

(b) Under the law of that State, the law of a territorial unit is the law applicable only if the depositary bank has an office within that territorial unit which satisfies the condition specified in the second sentence of recommendation 210 (alternative B); and

(c) The provision described in subparagraph (b) of this recommendation is in force at the time the security right in the bank account is created.⁴⁰

XI. Transition

Purpose

The purpose of provisions on transition is to provide a fair and efficient transition to the law from the regime in force before the effective date of the law.

Effective date

228. The law should specify either a date subsequent to its enactment on which it comes into force (the “effective date”) or a mechanism by which the effective date may be determined. From its effective date, the law applies to all transactions within its scope, whether entered into before or after that date, except as provided in recommendations 229-234.

⁴⁰Only a State that adopts alternative B of recommendation 210 needs to adopt recommendations 226 and 227.

Inapplicability of the law to actions commenced before the effective date

229. The law should provide that it does not apply to a matter that is the subject of litigation or alternative binding dispute resolution proceedings that were commenced before the effective date. If enforcement of a security right has commenced before the effective date, the enforcement may continue under the law in force before the effective date (“prior law”).

Creation of a security right

230. The law should provide that prior law determines whether a security right was created before the effective date.

Third-party effectiveness of a security right

231. The law should provide that a security right that is effective against third parties under prior law remains effective against third parties until the earlier of:

(a) The time it would cease to be effective against third parties under prior law; and

(b) The expiration of a period of [a period of time to be specified] months after the effective date (“the transition period”).

If the requirements for third-party effectiveness under this law are satisfied before third-party effectiveness would have ceased under the preceding sentence, third-party effectiveness is continuous.

Priority of a security right

232. Subject to recommendations 233 and 234, the law should provide that it governs the priority of a security right. The time when a security right referred to in recommendation 231 was made effective against third parties or became the subject of a registered notice under prior law is the time to be used in determining the priority of that right.

233. The law should provide that the priority of a security right is determined by prior law if:

(a) The security right and the rights of all competing claimants arose before the effective date; and

(b) The priority status of none of these rights has changed since the effective date.

234. The law should provide that the priority status of a security right has changed if:

(a) It was effective against third parties on the effective date as provided in recommendation 231 and later ceased to be effective against third parties; or

(b) It was not effective against third parties on the effective date and later became effective against third parties.

XII. The impact of insolvency on a security right

Purpose

The purpose of the recommendations in the present chapter is to address the impact of insolvency on security rights in a comprehensive way that is consistent with the UNCITRAL Insolvency Guide. Thus, core recommendations from the UNCITRAL Insolvency Guide that relate particularly to security rights are included in this chapter. For a more complete discussion of the impact of insolvency proceedings on security rights, however, this chapter should be read together with both the commentary and the recommendations of the UNCITRAL Insolvency Guide. This chapter also includes discussion of some additional recommendations elaborating on issues discussed in the UNCITRAL Insolvency Guide but not the subject of recommendations in that Guide.

A. UNCITRAL Legislative Guide on Insolvency Law:⁴¹ terminology and recommendations

1. Terminology

12. (b) “Assets of the debtor”: property, rights and interests of the debtor, including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in encumbered assets or in third-party-owned assets;

12. (r) “Financial contract”: any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above;

12. (x) “*Lex fori concursus*”: the law of the State in which the insolvency proceedings are commenced;

12. (y) “*Lex situs*”: the law of the State in which the asset is situated;

12. (z) “Netting”: the setting-off of monetary or non-monetary obligations under financial contracts;

12. (aa) “Netting agreement”: a form of financial contract between two or more parties that provides for one or more of the following:

- (i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;

⁴¹United Nations publication, Sales No. E.05.V.10.

(ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or

(iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements.⁴²

12. *(dd)* “Party in interest”: any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest;

12. *(ff)* “Preference”: a transaction which results in a creditor obtaining an advantage or irregular payment;

12. *(gg)* “Priority”: the right of a claim to rank ahead of another claim where that right arises by operation of law;

12. *(hh)* “Priority claim”: a claim that will be paid before payment of general unsecured creditors;

12. *(ii)* “Protection of value”: measures directed at maintaining the economic value of encumbered assets and third-party-owned assets during the insolvency proceedings (in some jurisdictions referred to as “adequate protection”). Protection may be provided by way of cash payments, provision of security interests over alternative or additional assets or by other means as determined by a court to provide the necessary protection;

12. *(pp)* “Security interest”: a right in an asset to secure payment or other performance of one or more obligations.

2. *Recommendations*

Key objectives of an efficient and effective insolvency law

1. In order to establish and develop an effective insolvency law, the following key objectives should be considered:

- (a) Provide certainty in the market to promote economic stability and growth;
- (b) Maximize value of assets;
- (c) Strike a balance between liquidation and reorganization;
- (d) Ensure equitable treatment of similarly situated creditors;
- (e) Provide for timely, efficient and impartial resolution of insolvency;
- (f) Preserve the insolvency estate to allow equitable distribution to creditors;

⁴²United Nations Assignment Convention, article 5, subparagraph 1.

(g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and

(h) Recognize existing creditors' rights and establish clear rules for ranking of priority claims.

4. The insolvency law should specify that where a security interest is effective and enforceable under law other than the insolvency law, it will be recognized in insolvency proceedings as effective and enforceable.

7. In order to design an effective and efficient insolvency law, the following common features should be considered:

(a)-(d) ...

(e) Protection of the insolvency estate against the actions of creditors, the debtor itself and the insolvency representative and, where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(f)-(r) ...

Law applicable to validity and effectiveness of rights and claims

30. The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be determined by the private international law rules of the State in which insolvency proceedings are commenced.

Law applicable in insolvency proceedings: lex fori concursus

31. The insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

(a)-(i) ...

(j) Treatment of secured creditors;

(k)-(n) ...

(o) Ranking of claims;

(p)-(s) ...

Exceptions to the application of the law of the insolvency proceedings

...

34. Any exceptions additional to recommendations 32 and 33 should be limited in number and be clearly set forth or noted in the insolvency law.

Assets constituting the insolvency estate

35. The insolvency law should specify that the estate should include:

- (a) Assets of the debtor,⁴³ including the debtor's interest in encumbered assets and in third-party-owned assets;
- (b) Assets acquired after commencement of the insolvency proceedings; and
- (c) ...

Provisional measures⁴⁴

39. The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor⁴⁵ or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings,⁴⁶ including:

- (a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;
- (b)-(d) ...

Indemnification in connection with provisional measures

40. The insolvency law may provide the court with the power to:

- (a) Require the applicant for provisional measures to provide indemnification and, where appropriate, to pay costs or fees; or
- (b) Impose sanctions in connection with an application for provisional measures.

Balance of rights between the debtor and insolvency representative

41. The insolvency law should clearly specify the balance of the rights and obligations between the debtor and any insolvency representative appointed as a provisional measure. Between the time an application for commencement of insolvency proceedings is made and commencement of those proceedings, the debtor is entitled to continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

⁴³Ownership of assets would be determined by reference to the relevant applicable law, where the term "assets" is defined broadly to include property, rights and interest of the debtor, including the debtor's rights and interests in third-party-owned assets.

⁴⁴These articles follow the corresponding articles of the UNCITRAL Model Law on Cross-Border Insolvency, see article 19 (see annex III of the UNCITRAL Insolvency Guide).

⁴⁵The reference to assets in paragraphs (a)-(c) is intended to be limited to assets that would be part of the insolvency estate once proceedings commence.

⁴⁶The insolvency law should indicate the time of effect of an order for provisional measures, for example, at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time (see para. 44 of the UNCITRAL Insolvency Guide).

Notice

42. The insolvency law should specify that, unless the court limits or dispenses with the need to provide notice, appropriate notice is to be given to those parties in interest affected by:

(a) An application or court order for provisional measures (including an application for review and modification or termination); and

(b) A court order for additional measures applicable on commencement, unless the court limits or dispenses with the need to provide notice.

Ex parte provisional measures

43. The insolvency law should specify that, where the debtor or other party in interest affected by a provisional measure is not given notice of the application for that provisional measure, the debtor or other party in interest affected by the provisional measures has the right, upon urgent application, to be heard promptly⁴⁷ on whether the relief should be continued.

Modification or termination of provisional measures

44. The insolvency law should specify that the court, at its own motion or at the request of the insolvency representative, the debtor, a creditor or any other person affected by the provisional measures, may review and modify or terminate those measures.

Termination of provisional measures

45. The insolvency law should specify that provisional measures terminate when:

(a) An application for commencement is denied;

(b) An order for provisional measures is successfully challenged under recommendation 43; and

(c) The measures applicable on commencement take effect, unless the court continues the effect of the provisional measures.

Measures applicable on commencement

46. The insolvency law should specify that, on commencement of insolvency proceedings:⁴⁸

(a) Commencement or continuation of individual actions or proceedings⁴⁹ concerning the assets of the debtor and the rights, obligations or liabilities of the debtor are stayed;

⁴⁷Any time limit included in the insolvency law should be short in order to prevent the loss of value of the debtor's business.

⁴⁸These measures would generally be effective as at the time of the making of the order for commencement.

⁴⁹See UNCITRAL Model Law on Cross-Border Insolvency, article 20 (see annex III of the UNCITRAL Insolvency Guide). It is intended that the individual actions referred to in subparagraph (a) of recommendation 46 would also cover actions before an arbitral tribunal. It may not always be possible, however, to implement the automatic stay of arbitral proceedings, such as where the arbitration does not take place in the State but in a foreign location.

- (b) Actions to make security interests effective against third parties and to enforce security interests are stayed;⁵⁰
- (c) Execution or other enforcement against the assets of the estate is stayed;
- (d) The right of a counterparty to terminate any contract with the debtor is suspended;⁵¹ and
- (e) The right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.⁵²

Duration of measures automatically applicable on commencement

49. The insolvency law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout those proceedings until:

- (a) The court grants relief from the measures;⁵³
- (b) In reorganization proceedings, a reorganization plan becomes effective;⁵⁴ or
- (c) In the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires,⁵⁵ unless it is extended by the court for a further period on a showing that:
 - (i) An extension is necessary to maximize the value of assets for the benefit of creditors; and
 - (ii) The secured creditor will be protected against diminution of the value of the encumbered asset in which it has a security interest.

Protection from diminution of the value of encumbered assets

50. The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the asset in which it has a security interest. The court may grant appropriate measures of protection that may include:

- (a) Cash payments by the estate;
- (b) Provision of additional security interests; or
- (c) Such other means as the court determines.

⁵⁰If law other than the insolvency law permits those security interests to be made effective within certain specified time periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the specified time period. Where law other than the insolvency law does not include such time periods, the stay applicable on commencement would operate to prevent the security interest from being made effective. (For further discussion, see para. 32 of the UNCITRAL Insolvency Guide and the *UNCITRAL Legislative Guide on Secured Transactions*.)

⁵¹See UNCITRAL Insolvency Guide, paras. 114-119. This recommendation is not intended to preclude the termination of a contract if the contract provides for a termination date that happens to fall after the commencement of insolvency proceedings.

⁵²The limitation on the right to transfer, encumber or otherwise dispose of assets of the estate may be subject to an exception in those cases where the continued operation of the business by the debtor is authorized and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.

⁵³Relief should be granted on the grounds included in recommendation 51 of the UNCITRAL Insolvency Guide.

⁵⁴A plan may become effective upon approval by creditors or following confirmation by the court, depending upon the requirements of the insolvency law (see UNCITRAL Insolvency Guide, chap. IV, paras. 54 ff.).

⁵⁵It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the insolvency law should clearly state the period of application.

Relief from measures applicable on commencement

51. The insolvency law should specify that a secured creditor may request the court to grant relief from the measures applicable on commencement of insolvency proceedings on grounds that may include that:

- (a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) The value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; and
- (c) In reorganization, a plan is not approved within any applicable time limits.

Power to use and dispose of assets of the estate

52. The insolvency law should permit:

- (a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and
- (b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

Further encumbrance of encumbered assets

53. The insolvency law should specify that an encumbered asset may be further encumbered, subject to the requirements of recommendations 65-67.

Use of third-party-owned assets

54. The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

- (a) The interests of the third party will be protected against diminution in the value of the asset; and
- (b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.

Ability to sell assets of the estate free and clear of encumbrances and other interests

58. The insolvency law should permit the insolvency representative to sell an asset that is encumbered or subject to other interest free and clear of that encumbrance and other interest, outside the ordinary course of business, provided that:

- (a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;

- (b) The holder is given the opportunity to be heard by the court where they object to the proposed sale;
- (c) Relief from the stay has not been granted; and
- (d) The priority of interests in the proceeds of sale of the asset is preserved.

Use of cash proceeds

59. The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

- (a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or
- (b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and
- (c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

Burdensome assets

62. The insolvency law should permit the insolvency representative to determine the treatment of any asset that is burdensome to the estate. In particular, the insolvency law may permit the insolvency representative to relinquish a burdensome asset following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset and the asset is not required for a reorganization or sale of the business as a going concern, the insolvency law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

Attracting and authorizing post-commencement finance

63. The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate. The insolvency law may require the court to authorize or creditors to consent to the provision of post-commencement finance.

Security for post-commencement finance

65. The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower-priority security interest on an already encumbered asset of the estate.

66. The law⁵⁶ should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

67. The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

- (a) The existing secured creditor was given the opportunity to be heard by the court;
- (b) The debtor can prove that it cannot obtain the finance in any other way; and
- (c) The interests of the existing secured creditor will be protected.⁵⁷

Effect of conversion on post-commencement finance

68. The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.⁵⁸

Automatic termination and acceleration clauses

70. The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

- (a) An application for commencement, or commencement, of insolvency proceedings;
- (b) The appointment of an insolvency representative.⁵⁹

71. The insolvency law should specify the contracts that are exempt from the operation of recommendation 70, such as financial contracts, or subject to special rules, such as labour contracts.

Continuation or rejection

72. The insolvency law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where continuation would be

⁵⁶This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

⁵⁷See UNCITRAL Insolvency Guide, paras. 63-69.

⁵⁸The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.

⁵⁹This recommendation would apply only to those contracts where such clauses could be overridden (see commentary of the UNCITRAL Insolvency Guide, paras. 143-145, on exceptions) and is not intended to be exclusive, but to establish a minimum: the court should be able to examine other contractual clauses that would have the effect of terminating a contract on the occurrence of similar events.

beneficial to the insolvency estate.⁶⁰ The insolvency law should specify that:

- (a) The right to continue applies to the contract as a whole; and
- (b) The effect of continuation is that all terms of the contract are enforceable.

73. The insolvency law may permit the insolvency representative to decide to reject a contract.⁶¹ The insolvency law should specify that the right to reject applies to the contract as a whole.

Continuation of contracts where the debtor is in breach

79. The insolvency law should specify that where the debtor is in breach of a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach and the estate is able to perform under the continued contract.

Performance prior to continuation or rejection

80. The insolvency law should specify that the insolvency representative may accept or require performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted or required by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

- (a) If the counterparty has performed the contract, the amount of the administrative expense should be the contractual price of the performance; or
- (b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against diminution of the value of those assets and have an administrative claim in accordance with subparagraph (a).

Damages for subsequent breach of a continued contract

81. The insolvency law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

Damages arising from rejection

82. The insolvency law should specify that any damages arising from the rejection of a pre-commencement contract would be determined in accordance with applicable law and

⁶⁰Provided the automatic stay on commencement of proceedings applies to prevent termination (pursuant to an automatic termination clause) of contracts with the debtor, all contracts should remain in place to enable the insolvency representative to consider the possibility of continuation, unless the contract has a termination date that happens to fall after the commencement of insolvency proceedings.

⁶¹An alternative to providing a power to reject contracts is the approach of those jurisdictions that provide that performance of a contract simply ceases unless the insolvency representative decides to continue its performance.

should be treated as an ordinary unsecured claim. The insolvency law may limit claims relating to the rejection of a long-term contract.

Assignment of contracts

83. The insolvency law may specify that the insolvency representative can decide to assign a contract, notwithstanding restrictions in the contract, provided the assignment would be beneficial to the estate.

84. Where the counterparty objects to assignment of a contract, the insolvency law may permit the court to nonetheless approve the assignment provided:

- (a) The insolvency representative continues the contract;
- (b) The assignee can perform the assigned contractual obligations;
- (c) The counterparty is not substantially disadvantaged by the assignment; and
- (d) The debtor's breach under the contract is cured before assignment.

85. The insolvency law may specify that, where the contract is assigned, the assignee will be substituted for the debtor as the contracting party with effect from the date of the assignment and the estate will have no further liability under the contract.

*Avoidable transactions*⁶²

87. The insolvency law should include provisions that apply retroactively and are designed to overturn transactions, involving the debtor or assets of the estate, and that have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The insolvency law should specify the following types of transaction as avoidable:

(a) Transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the effect of the transaction was to put assets beyond the reach of creditors or potential creditors or to otherwise prejudice the interests of creditors;

(b) Transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was a gift or was made in exchange for a nominal or less-than-equivalent value or for inadequate value that occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

(c) Transactions involving creditors where a creditor obtained, or received the benefit of, more than its pro rata share of the debtor's assets that occurred at a time when the debtor was insolvent (preferential transactions).

⁶²The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, granting of a security interest, a guarantee, a loan or a release or an action to make a security interest effective against third parties and may include a composite series of transactions.

Avoidance of security interests

88. The insolvency law should specify that, notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

Transactions exempt from avoidance actions

92. The insolvency law should specify the transactions that are exempt from avoidance, including financial contracts.

Financial contracts and netting

103. Once the financial contracts of the debtor have been terminated, the insolvency law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

Participation by creditors

126. The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

Right to be heard and to request review

137. The insolvency law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled:

- (a) To object to any act that requires court approval;
- (b) To request review by the court of any act for which court approval was not required or not requested; and
- (c) To request any relief available to it in insolvency proceedings.

*Right of appeal*⁶³

138. The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

⁶³In accordance with the key objectives, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings.

Reorganization plan

Voting mechanisms

145. The insolvency law should establish a mechanism for voting on approval of the plan. The mechanism should address the creditors and equity holders who are entitled to vote on the plan; the manner in which the vote will be conducted, either at a meeting convened for that purpose or by mail or other means, including electronic means and the use of proxies; and whether or not creditors and equity holders should vote in classes according to their respective rights.

146. The insolvency law should specify that a creditor or equity holder whose rights are modified or affected by the plan should not be bound to the terms of the plan unless that creditor or equity holder has been given the opportunity to vote on approval of the plan.

147. The insolvency law should specify that where the plan provides that the rights of a creditor or equity holder or class of creditors or equity holders are not modified or affected by a plan, that creditor or equity holder or class of creditors or equity holders is not entitled to vote on approval of the plan.

148. The insolvency law should specify that creditors entitled to vote on approval of the plan should be separately classified according to their respective rights and that each class should vote separately.

149. The insolvency law should specify that all creditors and equity holders in a class should be offered the same treatment.

Approval by classes

150. Where voting on approval of the plan is conducted by reference to classes, the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring approval by all classes or approval by a specified majority of the classes, but at least one class of creditors whose rights are modified or affected by the plan must approve the plan.

151. Where the insolvency law does not require a plan to be approved by all classes, the insolvency law should address the treatment of those classes which do not vote to approve a plan that is otherwise approved by the requisite classes. That treatment should be consistent with the grounds set forth in recommendation 152.

Confirmation of an approved plan

152. Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

(a) The requisite approvals have been obtained and the approval process was properly conducted;

(b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;

(c) The plan does not contain provisions contrary to law;

(d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and

(e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

Challenges to approval (where there is no requirement for confirmation)

153. Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit parties in interest, including the debtor, to challenge the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed, which should include:

(a) Whether the grounds set forth in recommendation 152 are satisfied; and

(b) Fraud, in which case the requirements of recommendation 154 should apply.

Secured claims

172. The insolvency law should specify whether secured creditors are required to submit claims.

Unliquidated claims

178. The insolvency law should permit unliquidated claims to be admitted provisionally, pending determination of the amount of the claim by the insolvency representative.

Valuation of secured claims

179. The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

Secured claims

188. The insolvency law should specify that a secured claim should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

B. Additional insolvency recommendations

Assets acquired after commencement of insolvency proceedings

235. Except as provided in recommendation 236, the insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings is not subject to a security right created by the debtor before the commencement of the insolvency proceedings.

236. The insolvency law should provide that an asset of the estate acquired after the commencement of insolvency proceedings with respect to the debtor is subject to a security right created by the debtor before the commencement of the insolvency proceedings to the extent the asset constitutes proceeds (whether cash or non-cash) of an encumbered asset that was an asset of the debtor before commencement.

Automatic termination clauses in insolvency proceedings

237. If the insolvency law provides that a contract clause that, upon the commencement of insolvency proceedings or the occurrence of another insolvency-related event, automatically terminates any obligation under a contract or accelerates the maturity of any obligation under a contract, is unenforceable as against the insolvency representative or the debtor, the insolvency law should also provide that such provision does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations to the benefit of the debtor.

Third-party effectiveness of a security right in insolvency proceedings

238. The insolvency law should provide that, if a security right is effective against third parties at the time of the commencement of insolvency proceedings, action may be taken after the commencement of the insolvency proceedings to continue, preserve or maintain the effectiveness against third parties of the security right to the extent and in the manner permitted under the secured transactions law.

Priority of a security right in insolvency proceedings

239. The insolvency law should provide that, if a security right is entitled to priority under law other than insolvency law, the priority continues unimpaired in insolvency proceedings except if, pursuant to insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to recommendation 188 of the UNCITRAL Insolvency Guide.

Effect of a subordination agreement in insolvency proceedings

240. The insolvency law should provide that, if a holder of a security right in an asset of the insolvency estate subordinates its priority unilaterally or by agreement in favour of

any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the debtor to the same extent that such subordination is effective under non-insolvency law.

Costs and expenses of maintaining value of the encumbered asset in insolvency proceedings

241. The insolvency law should provide that the insolvency representative is entitled to recover on a first priority basis from the value of an encumbered asset reasonable costs and expenses incurred by the insolvency representative in maintaining, preserving or increasing the value of the encumbered asset for the benefit of the secured creditor.

Valuation of encumbered assets in reorganization proceedings

242. The insolvency law should provide that, in determining the liquidation value of encumbered assets in reorganization proceedings, consideration should be given to the use of those assets and the purpose of the valuation. The liquidation value of those assets may be based on their value as part of a going concern.

Annex II

Resolution of the United Nations Commission on International Trade Law and General Assembly resolution 63/121

A. Resolution of the Commission

1. At its 864th meeting, on 14 December 2007, the Commission adopted the following resolution:

The United Nations Commission on International Trade Law,

Recognizing the importance to all countries of efficient secured transactions regimes promoting access to secured credit,

Recognizing also that access to secured credit is likely to assist all countries, in particular developing countries and countries with economies in transition, in their economic development and in fighting poverty,

Noting that increased access to secured credit on the basis of modern and harmonized secured transactions regimes will demonstrably promote the movement of goods and services across national borders,

Noting also that the development of international trade on the basis of equality and mutual benefit is an important element in promoting friendly relations among States,

Noting further the importance of balancing the interests of all stakeholders, including grantors of security rights, secured and unsecured creditors, retention-of-title sellers and financial lessors, privileged creditors and the insolvency representative in the grantor's insolvency,

Taking into account the need for reform in the field of secured transactions laws at both the national and international levels as demonstrated by the numerous national law reform efforts under way and the work of international organizations, such as the Hague Conference on Private International Law, the International Institute for the Unification of Private Law (Unidroit) and the Organization of American States, and of international financial institutions, such as the Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the International Monetary Fund and the World Bank,

Expressing its appreciation to international intergovernmental and non-governmental organizations active in the field of secured transactions law reform for their participation in and support for the development of the draft UNCITRAL Legislative Guide on Secured Transactions,

Expressing also its appreciation to Kathryn Sabo, Chairperson of Working Group VI (Security Interests) and the acting Chairperson at the resumed fortieth session of the Commission, as well as to the Secretariat, for their special contribution to the development of the draft UNCITRAL Legislative Guide on Secured Transactions,

Noting with satisfaction that the draft UNCITRAL Legislative Guide on Secured Transactions is consistent with the UNCITRAL Legislative Guide on Insolvency Law with regard to the treatment of security rights in insolvency proceedings,

1. *Adopts* the UNCITRAL Legislative Guide on Secured Transactions, consisting of the text contained in documents A/CN.9/631/Add.1-3 and A/CN.9/637 and Add.1-8, with the amendments adopted by the Commission at its fortieth session, and authorizes the Secretariat to edit and finalize the text of the Guide pursuant to the deliberations of the Commission at that session;

2. *Requests* the Secretary-General to disseminate broadly the text of the UNCITRAL Legislative Guide on Secured Transactions, transmitting it to Governments and other interested bodies, such as national and international financial institutions and chambers of commerce;

3. *Recommends* that all States utilize the UNCITRAL Legislative Guide on Secured Transactions to assess the economic efficiency of their secured transactions regimes and give favourable consideration to the Guide when revising or adopting legislation relevant to secured transactions, and invites States that have used the Guide to advise the Commission accordingly.

B. General Assembly resolution 63/121

2. At its 67th plenary meeting, on 11 December 2008, the General Assembly adopted, on the basis of the report of the Sixth Committee (A/63/438), the following resolution:

Legislative Guide on Secured Transactions of the United Nations Commission on International Trade Law

The General Assembly,

Recognizing the importance to all countries of efficient secured transactions regimes promoting access to secured credit,

Recognizing also that access to secured credit is likely to assist all countries, in particular developing countries and countries with economies in transition, in their economic development and in fighting poverty,

Emphasizing the expectation that modern and harmonized secured transactions regimes which balance the interests of all stakeholders (including grantors of security rights, secured and unsecured creditors, retention-of-title sellers and financial lessors, privileged creditors and the insolvency representative in the grantor's insolvency) will demonstrably facilitate access to secured credit, thereby promoting the movement of goods and services across national borders,

Noting that the development of international trade on the basis of equality and mutual benefit is an important element in promoting friendly relations among States,

Taking into account the need for reform in the field of secured transactions laws at both the national and international levels as demonstrated by the numerous current national law reform efforts and the work of international organizations, such as the Hague Conference on Private International Law, the International Institute for the Unification of Private Law and the Organization of American States, and of international financial institutions, such as the Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the International Monetary Fund and the World Bank,

Expressing its appreciation to intergovernmental and international non-governmental organizations active in the field of secured transactions law reform for their participation in and support for the development of the Legislative Guide on Secured Transactions of the United Nations Commission on International Trade Law,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for the completion and adoption of the Legislative Guide on Secured Transactions;¹

2. *Requests* the Secretary-General to disseminate broadly the text of the Legislative Guide, transmitting it to Governments and other interested bodies, such as national and international financial institutions and chambers of commerce;

3. *Recommends* that all States give favourable consideration to the Legislative Guide when revising or adopting legislation relevant to secured transactions, and invites States that have used the Legislative Guide to advise the Commission accordingly;

4. *Recommends also* that all States continue to consider becoming party to the United Nations Convention on the Assignment of Receivables in International Trade,² the principles of which are also reflected in the Legislative Guide.

¹See *Official Records of the General Assembly, Sixty-second Session, Supplement No. 17 (A/62/17)*, part two, para. 100.

²Resolution 56/81, annex.

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