
General Assembly

Distr.: Limited
30 September 2002



Original: English

United Nations Commission on International Trade Law

Working Group VI (Security Interests)
Second session
Vienna, 17-20 December 2002

Draft legislative guide on secured transactions

Report of the Secretary-General

Background remarks

1. 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 security interests was an important subject and had been brought to the attention of the Commission at the right time, in particular in view of the close link of security interests with the work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck, however, in that regard to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States. It was also stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable. Furthermore, in order to ensure the optimal benefits from law reform, including financial-crisis prevention, poverty reduction and facilitation of debt financing as an engine for economic growth, any effort on security interests would need to be co-ordinated with efforts on insolvency law.¹

2. At its thirty-fourth session in 2001, the Commission considered a further report by the Secretariat (A/CN.9/496). At that session, the Commission agreed that work should be undertaken in view of the beneficial economic impact of a modern secured credit law. It was stated that experience had shown that deficiencies in that area could have major negative

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

effects on a country's economic and financial system. It was also stated that an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist the banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate restructuring by providing a vehicle that would create incentives for interim financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.²

3. While some concerns were expressed with respect to the feasibility of work in the field of secured credit law, the Commission noted that those concerns were not widely shared and went on to consider the scope of work.³ It was widely felt that work should focus on security interests in goods involved in a commercial activity, including inventory. It was also agreed that securities and intellectual property should not be dealt with as matters of priority. With respect to securities, the Commission noted the interest of the International Institute on Private Law (Unidroit). As to intellectual property, it was stated that there was less need for work in that area, the issues were extremely complex and any efforts to address them should be co-ordinated with other organizations, such as the World Intellectual Property Organization (WIPO).⁴ As to the form of work, the Commission considered that a model law might be too rigid and noted the suggestions made for a set of principles with a legislative guide that would include, where feasible, model legislative provisions.⁵

4. After discussion, the Commission decided to entrust a working group with the task of developing "an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, such as the form of the instrument, the exact scope of the assets that can serve as collateral ...".⁶ Emphasizing the importance of the matter and the need to consult with representatives of the relevant industry and practice, the Commission recommended that a two- to three-day colloquium be held.⁷

5. At its first session (New York, 20-24 May 2002), Working Group VI (Security Interests) had before it a first, preliminary draft legislative guide on secured transactions, prepared by the Secretariat (A/CN.9/WG.VI/WP.2 and Addenda 1 to 12), a report on an UNCITRAL-CFA international colloquium, held in Vienna from 20 to 22 March 2002 (A/CN.9/WG.VI/WP.3), and comments by the European Bank for Reconstruction and Development (A/CN.9/WG.VI/WP.4). At that session, the Working Group considered chapters I to V and X (A/CN.9/WG.VI/WP.2 and Addenda 1 to 5 and 10), and requested the

² Ibid., Fifty-sixth Session, Supplement No. 17 (A/56/17), para. 351.

³ Ibid., para. 352-354.

⁴ Ibid., paras. 354-356.

⁵ Ibid., para. 357.

⁶ Ibid., para. 358.

⁷ Ibid., para. 359.

Secretariat to revise these chapters (A/CN.9/512, para. 12). At the same session, the Working Group agreed on the need to ensure, in cooperation with Working Group V (Insolvency Law), that issues relating to the treatment of security rights in insolvency proceedings would be addressed consistently with the conclusions of Working Group V on the intersection of the work of Working Group V and Working Group VI (see A/CN.9/512, para. 88 and A/CN.9/511, paras. 126-127).

6. At its thirty-fifth session in 2002, the Commission had before it the report of Working Group VI (Security Interests) on the work of its first session (A/CN.9/512). The Commission expressed its appreciation to the Working Group for the progress made in its work. It was widely felt that, with that legislative guide, the Commission had a great opportunity to assist States in adopting modern secured transactions legislation, which was generally thought to be a necessary, albeit not sufficient in itself, condition for increasing access to low-cost credit, thus facilitating the cross-border movement of goods and services, economic development and ultimately friendly relations among nations.

7. In addition, the feeling was widely shared that the timing of the Commission's initiative was most opportune both in view of the relevant legislative initiatives under way at the national and the international level and in view of the Commission's own initiative in the field of insolvency law. In that connection, the Commission noted with particular satisfaction the efforts undertaken by Working Group VI and Working Group V (Insolvency Law) towards coordinating their work on a subject of common interest such as the treatment of security interests in the case of insolvency proceedings. Strong support was expressed for such coordination, which was generally thought to be of crucial importance for providing States with comprehensive and consistent guidance with respect to the treatment of security interests in insolvency proceedings. The Commission endorsed a suggestion made to revise the insolvency chapter of the draft legislative guide on secured transactions in light of the core principles agreed by Working Groups V and VI (see A/CN.9/511, paras. 126-127 and A/CN.9/512, para. 88). The Commission stressed the need for continued coordination and requested the secretariat to consider organizing a joint session of the two Working Groups in December 2002.

8. After discussion, the Commission confirmed the mandate given to the Working Group at its thirty-fourth session to develop an efficient legal regime for security interests in goods, including inventory.⁸ The Commission also confirmed that the mandate of the Working Group should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.⁹

9. Addenda to this introductory document contain Chapters I to V (combined with Chapter VI) and X of the revised draft legislative guide on secured transactions: Chapter I, Introduction, and Chapter II, Key objectives of an efficient secured transactions regime (A/CN.9/WG.VI/WP.6/Add.1); Chapter III: Basic approaches to security (A/CN.9/WG.VI/WP.6/Add.2); Chapter IV, Creation of security rights

⁸ Ibid., para. 358.

⁹ Ibid., Fifty-seventh Session, Supplement No. 17 (A/57/17), paras. 202-204.

(A/CN.9/WG.VI/WP.6/Add.3); Chapter V, Publicity, combined with Chapter VI, Publicity via filing (A/CN.9/WG.VI/WP.6/Add.4) and Chapter IX, Insolvency (A/CN.9/WG.VI/WP.6/Add.5).

10. The remaining Chapters are contained in Addenda to the first draft of the legislative guide: Chapter VII, Priority (A/CN.9/WG.VI/WP.2/Add.7); Chapter VIII, Pre-default rights and obligations of the parties (A/CN.9/WG.VI/WP.2/Add.8); Chapter IX, Default and enforcement (A/CN.9/WG.VI/WP.2/Add.9); Chapter XI, Conflict of laws and territorial application (A/CN.9/WG.VI/WP.2/Add.11) and Chapter XII, Transition issues (A/CN.9/WG.VI/WP.2/Add.12).

General AssemblyDistr.: Limited
1 October 2002

Original: English

**United Nations Commission
on International Trade Law**Working Group VI (Security Interests)
Second session
Vienna, 16-20 December 2002**Security Interests****Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-36	2
I. Introduction	1-26	2
A. Purpose and scope of the Guide	1-13	2
B. Terminology	14	4
C. Examples of financing practices to be covered in the Guide	15-26	6
1. Inventory and equipment purchase-money financing	16-20	6
2. Receivable and inventory revolving loan financing	21-23	7
3. Term loan financing	24-26	7
II. Key objectives of an efficient secured transactions regime	27-36	8
A. Allow a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions	28	8
B. Obtain security rights in a simple and efficient manner	29	8
C. Recognize party autonomy	30	8
D. Provide for equal treatment of domestic and non-domestic creditors	31	9
E. Validate non-possessory rights	32	9
F. Encourage responsible behaviour by enhancing predictability and transparency	33	9
G. Establish clear and predictable priority rules	34	9
H. Facilitate enforcement of creditor's rights in a predictable and efficient manner	35	9
I. Balance the interests of the affected persons	36	9

Draft legislative guide on secured transactions

[Prefatory remarks to be prepared at a later stage]

I. Introduction

A. Purpose and scope

1. The purpose of this Guide is to assist States in the development of modern secured transactions laws, with the goal of promoting the availability of low-cost 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 review or modernize them, or to harmonize or co-ordinate their laws with those of other States.

2. The Guide is based on the premise that sound secured transactions laws can have many benefits for States that adopt them, including attracting credit from domestic as well as from foreign creditors, promoting the development and growth of domestic businesses, and generally promoting trade. Such laws also can result in benefits for consumers by lowering the cost of goods and services and promoting the availability of low-cost consumer credit. To be effective in promoting the availability of low-cost credit, such 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.

3. The Guide seeks to rise above differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable and limited costs to develop and 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 manufacturers, distributors, service providers or retailers, 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, the International Monetary Fund, the Asian Development Bank 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 credit risk for the creditor. Risk is reduced because credit secured by the assets of a business gives creditors access to the assets as another source of payment in the event of non-payment by the debtor. As the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls. On the other hand, in States where creditors perceive the risks associated with credit transactions to be high, the cost of credit increases as creditors require increased compensation to evaluate and assume the increased risk.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit.

Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. 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 consumers, as well as for small and medium commercial enterprises.

7. Creating a legal regime that promotes secured credit not only aids in the cultivation and growth of individual businesses, but also can have a positive effect upon the economic prosperity of States. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves a valuable potential economic benefit.

8. To best promote the availability of low-cost secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their property to the maximum extent possible to obtain credit. The primary focus of the Guide is consensual security rights in movables, and the Guide suggests that a broad range of movables be permitted to serve as encumbered assets, including inventory, equipment and receivables. In addition to movables, the Guide covers immovables that are fixtures, and also recommends the recognition of a security device (sometimes referred to as an “enterprise mortgage”) under which an enterprise may create a security right in all or substantially all of its assets (including immovables) so long as this security device does not inappropriately conflict with other laws dealing with real property. Although the Guide focuses on consensual security rights, it also contains references to non-consensual security rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.2/Add.7, paras. 33-38).

9. The Guide does not cover security rights in securities as original encumbered assets (as to rights in proceeds, see ...). The nature of securities and their importance for the functioning of financial markets gives rise to a broad range of issues that merit special legislative treatment. These issues are the subject of a text being prepared by the International Institute for the Unification of Private Law (UNIDROIT). The law applicable to security and other rights in securities is addressed in a convention being prepared by the Hague Conference on Private International Law. The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts being prepared by UNIDROIT and the Hague Conference. [*Note to the Working Group: In due course, the Working Group may wish to expand on this matter.*]

10. Because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the mutual recognition of security rights validly created in other jurisdictions. This would represent a marked improvement over the laws currently in effect in many States, under which security rights often are lost once an encumbered asset is transported across national borders, and would go far toward encouraging creditors to extend credit in cross-border transactions.

11. Various concerns with respect to secured credit have been voiced. For example, providing a creditor with a priority claim to all or substantially all of a grantor’s assets (who may be the debtor or a third party, see Terminology, Section B) may appear to limit the ability of the grantor to obtain financing from other sources. Additionally, a secured creditor can wield significant influence over a grantor’s business, as the creditor may seize, or threaten seizure of, the encumbered assets upon default. There is also the further concern that secured creditors will effectively take most or all of an insolvent grantor’s

assets and leave little for unsecured creditors, some of whom are not in a position to bargain for a security right in the grantor's assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, the Guide suggests solutions.

12. Throughout, the Guide seeks to establish a balance between the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, purchasers and other transferees and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that creditors will accept such a balanced approach, and will thereby be encouraged to extend low-cost credit, so long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will realize the economic value of the encumbered assets. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization of an insolvent debtor. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since this matter does not lend itself to unification.

13. The Guide builds on the work of UNCITRAL and other organizations. Such work includes: the United Nations Convention on the Assignment of Receivables in International Trade, adopted in December 2001; the Convention on International Interests in Mobile Equipment, approved in November 2001; the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD General principles of a modern secured transactions law, completed in 1997; the study on Secured Transactions Law Reform in Asia, prepared by the Asian Development Bank in 2000; the OAS Model Inter-American Law on Secured Transactions, prepared in 2002; [...].

B. Terminology

14. This Guide has adopted terminology to express the concepts that underlie a secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given the term may differ. This approach is taken to provide readers a common vocabulary and conceptual framework and to encourage transnational harmonization of the law governing security rights. The following paragraphs therefore identify the principal terms used and the core meaning given to them in this Guide. The meaning of these terms is further refined when the terms are used in subsequent chapters. Those chapters also define and use additional terms.

Security right	A “security right” is a consensual <i>in rem</i> right in movable property [and fixtures] that secures payment or other performance of one or more obligations.
Secured obligation	A “secured obligation” is the obligation secured by a security right.
Secured creditor	A “secured creditor” is a creditor that has a security right.
Debtor	A “debtor” is a person that owes performance of the secured obligation. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor).

Grantor	A “grantor” is a person that creates a security right in one or more of its assets in favour of a secured creditor. The grantor may or may not be the debtor that owes performance of the secured obligation (see debtor).
Security agreement	A “security agreement” is an agreement between a grantor and a creditor which creates a security right that secures one or more of the debtor’s obligations.
Encumbered assets	An “encumbered asset” is property subject to a security right. In general, encumbered assets are divided into tangible and intangible property. Each of these two general classes comprises several sub-types.
Tangibles	The term “tangibles” includes all forms of tangible movable property. Among the sub-types of tangibles are inventory, equipment, and fixtures.
Inventory	“Inventory” includes not only a stock of tangibles held for sale or lease in the usual course of business but also raw and semi-processed materials.
Equipment	“Equipment” means tangibles, other than inventory, used by a person in the operation of its business.
Fixtures	The term “fixtures” means tangibles that have become immovable property under the law of the State where the immovable property is situated.
Intangibles	The term “intangibles” covers all movable property other than tangibles. Among the sub-types of intangibles are claims and receivables.
Claims	The term “claims” includes both a receivable and a right to the performance of a non-monetary obligation.
Receivable	A “receivable” is a right to the payment of a monetary sum.
Proceeds	The term “proceeds” includes [the fruits of encumbered assets and] whatever is received on the disposition of encumbered assets.
Priority	The “priority” of a secured creditor refers to the extent to which the secured creditor may derive the economic benefit of its security right in preference to other parties with a right in the same encumbered asset. Rules of priority rank security rights and other property rights in encumbered assets in the order in which they are to be satisfied out of the encumbered assets.
Possessory security right	A “possessory security right” is a security right in encumbered assets in the possession of a secured creditor or of its agent other than the grantor.
Non-possessory security right	A “non-possessory security right” is a security right in intangible encumbered assets and in tangible encumbered assets in the possession of the grantor or of its agent.
Insolvent debtor	An “insolvent debtor” is a person that is subject to insolvency proceedings. If a security right has been granted by a third party grantor, the Guide refers to an “insolvent grantor”.

Insolvency proceedings

“Insolvency proceedings” are collective proceedings that involve the partial or total divestment of the insolvent debtor and the appointment of an insolvency representative for the purpose of either liquidation or reorganization of the insolvent debtor’s assets or affairs.

Insolvency representative

An “insolvency representative” is a person, designated by law or appointed by a court, that is in charge of administering the insolvent debtor’s assets or affairs for the purpose of either the liquidation or reorganization of those assets or affairs. Insolvency representatives include insolvent debtors left in possession to administer their assets or affairs in reorganization proceedings in those legal regimes where this is permitted.

C. Examples of financing practices to be covered in the Guide

15. Set forth below are three short examples of the types of secured credit transactions that the Guide is designed to encourage, and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use, and an effective secured transactions regime must be sufficiently flexible to accommodate many existing modes of financing, as well as modes that may evolve in the future.

[Note to the Working Group: In order to avoid distracting the reader with an overly complex discussion, only a few limited examples of the most basic and common transactions are given. Other examples of some of the more complex transactions, such as project finance and securitization, may be added by the Working Group, if necessary to illustrate points made in the Guide.]

1. Inventory and equipment purchase-money financing

16. Businesses often desire to finance specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the goods. In other cases, the financing is provided by a lender instead of the seller. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller.

17. This type of financing is often referred to as “purchase money financing” and occurs in a number of different legal forms (e.g. retention of title). In many States, the seller retains by agreement title to the goods sold until the credit is paid in full. These types of transactions are generally referred to as retention of title arrangements or conditional sales agreements (see also A/CN.9/WP.6/Add.2, paras. ...). In other States, the seller or lender is granted by agreement a security right in the goods sold to secure the repayment of the credit or loan.

18. Here is an example of “purchase money financing”: Agrico is a manufacturer and distributor of agricultural equipment with facilities located in State X and customers located in multiple States. Agrico desires to purchase 10,000 units of paint from Vendor A and 5,000 wheels from Vendor B, and to lease certain manufacturing equipment from Lessor A, all of which will be used by Agrico in manufacturing certain types of agricultural equipment.

19. Under the purchase agreement with Vendor A, Agrico is required to pay the purchase price for the paint within thirty days of delivery to Agrico, and Vendor A retains

title to the units until Agrico pays the purchase price in full. Under the purchase agreement with Vendor B, Agrico is required to pay the purchase price for the wheels before they are delivered to Agrico. Agrico obtains a loan from Lender A to finance the purchase of the wheels from Vendor B. The loan is secured by the wheels being purchased.

20. Under the lease agreement with Lessor A, Agrico leases the manufacturing equipment from Lessor A for a period of two years. Agrico is required to make monthly lease payments during the lease term. Agrico has the option to purchase the manufacturing equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the manufacturing equipment during the lease term. Title will transfer to Agrico at the end of the lease term if Agrico exercises the purchase option.

2. Receivable and inventory revolving loan financing

21. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. 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.

22. One highly effective method of providing such working capital is a revolving loan facility. Under this type of facility, loans secured by the borrower's existing and future receivables and inventory are made from time to time at the request of the borrower to fund the borrower's working capital needs (see also A/CN.9/WG.VI/WP.6/Add.3, para. ...). The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower.

23. Here is an example of this type of financing: Agrico is a manufacturer and distributor of agricultural equipment with facilities located in State X and customers located in multiple States. It typically takes four months for Agrico to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving line of credit to Agrico to finance this process. Under the line of credit, Agrico may obtain loans from time to time in an aggregate amount of up to 80% of the value of its receivables and of up to 50% of the value of its inventory. Agrico is expected to repay these loans from time to time as it receives payments from its customers. The line of credit is secured by all of Agrico's existing and future receivables and inventory.

3. Term loan financing

24. Businesses often need to obtain financing for large, non-ordinary course expenditures, such as the construction of a new manufacturing plant. In these situations, businesses often seek financing that is not repayable until long after construction is completed. This type of facility is typically referred to as a term loan. In many cases, a term loan is amortized in accordance with an agreed-upon payment schedule, while in other cases the principal balance may be repayable in full at the end of the term.

25. For businesses that do not have strong, well-established credit ratings, term loan financing will typically only be available to the extent that the business is able to grant security rights in assets to secure the financing. The amount of the financing will be based

in part on the creditor's estimated net realizable value of the assets securing the financing. In many States, real property is the only type of asset that generally secures term loan financing. However, many businesses, particularly newly-established businesses, do not own any real property and, therefore, may not have access to term loan financing. In other States, term loans secured by other assets, such as equipment and even intellectual property, are common.

26. Here is an example of this type of financing: Agrico is a manufacturer and distributor of agricultural equipment with facilities located in State X and customers located in multiple States. Agrico desires to expand its operations and construct a new manufacturing plant in State Y. Agrico obtains a loan from Lender C to finance such construction. The loan is repayable in equal monthly installments over a period of ten years. The loan is secured by the new manufacturing plant, including all equipment located in the plant at the time of the conclusion of the financing contract and thereafter.

II. Key objectives of an effective and efficient secured transactions regime

27. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime:

A. Allow a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions

28. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (i) permitting a broad range of assets to serve as encumbered assets (including inventory, equipment, and receivables); (ii) permitting a broad range of obligations (including future obligations) to be secured; and (iii) extending the benefits of the regime to a broad array of debtors, creditors and credit transactions.

B. Obtain security rights in a simple and efficient manner

29. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include: eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in after-acquired property without additional actions on the part of the parties.

C. Recognize party autonomy

30. Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the Guide stresses the importance of party autonomy, while at the same time protecting the legitimate interests of all persons (especially consumers) affected by the transaction.

D. Provide for equal treatment of domestic and non-domestic creditors

31. Because healthy competition among all potential creditors (both domestic and non-domestic) is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to domestic and non-domestic creditors.

E. Validate non-possessory security rights

32. Because the granting of a security right should not make it difficult or impossible for the grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in encumbered assets coupled with mechanisms for publicizing the existence of such security rights.

F. Encourage responsible behaviour by enhancing predictability and transparency

33. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting, and addressing, confidentiality concerns.

G. Establish clear and predictable priority rules

34. A security right will have little or no value to a creditor unless the creditor is able to ascertain its priority in the property relative to other creditors (including an insolvency representative for the grantor). Thus, the Guide proposes clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

H. Facilitate enforcement of creditor's rights in a predictable and efficient manner

35. A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner, including realizing the full economic value of the security right in the event of the insolvency of the grantor. The Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review, when appropriate, and recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws.

I. Balance the interests of the affected persons

36. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors (including secured, privileged and unsecured creditors, purchasers and other transferees, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.



General Assembly

Distr.: Limited
16 October 2002*

Original: English

United Nations Commission on International Trade Law

Working Group VI (Security Interests)

Second session

Vienna, 17-20 December 2002

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

Contents

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-54	2
III. Basic approaches to security.	1-54	2
A. General remarks	1-47	2
1. Introduction.	1-2	2
2. Instruments traditionally designed for security.	3-28	2
a. Security rights in tangible movable property	3-23	2
b. Security rights in intangible movable property.	24-28	7
3. The use of title for security purposes	29-42	8
a. Transfer of title to the creditor	30-33	8
b. Retention of title by the creditor.	34-42	9
4. Uniform comprehensive security.	43-47	11
B. Summary and recommendations	48-54	12

* This document is submitted two weeks later than the required ten weeks prior to the start of the meeting because of the need to accommodate the completion of consultations.

III. Basic approaches to security

A. General remarks

1. Introduction

1. Over time, a broad variety of practices have been developed in different countries to secure a creditor's claims (usually for monetary payment) against its debtor. It is the purpose of this chapter to provide a broad survey of the various major approaches for affording the creditor effective means of security; the advantages and disadvantages of each approach to both the immediate parties involved, i.e. creditor and debtor, and third parties; and the major policy options for legislators.

2. In a general sense, it is possible to distinguish three major types of instruments that are used for the purposes of security. These are, first, instruments designed for and openly denominated as security (see section A.2); second, the recourse to title (ownership) for purposes of security combined with various types of contractual arrangements (see section A.3); and, third, a uniform comprehensive security (see section A.4).

2. Instruments traditionally designed for security

a. Security rights in tangible movable property

3. Traditionally, most countries distinguish between proprietary security rights in tangible movable property ("tangibles"; see section A.2.a) and those in intangible movable property ("intangibles"; see section A.2.b). In fact, the tangible nature of an asset gives rise to forms of security that are not available for intangibles (see paras. 8, and 25-26).

4. Within the group of security rights in tangibles, most countries draw a distinction based upon whether the encumbered assets must be transferred into the possession of the creditor (or a third party) or whether the debtor (or a third party) granting the security can retain possession. The former alternative is designated as possessory security (see section A.2.a.i) and the latter alternative as non-possessory security (see section A.2.a.ii).

i. Possessory security

(a) Pledge

5. By far the most common (and also ancient) form of possessory security in tangibles is the pledge. A pledge requires for its validity that the debtor (references to "the debtor" should be understood as references to "the grantor" where security is granted by a third party in favour of the debtor) effectively give up possession of the encumbered tangibles and that these be transferred either to the secured creditor or to a third party agreed upon by the parties (e.g. a warehouse). The actual holder may also be an agent or trustee who holds the security in the name, or at least for the account, of the creditor or a syndicate of creditors. The required dispossession of the debtor must not only occur at the creation of the security right but it must be

maintained during the life of the pledge; return of the encumbered assets to the debtor usually extinguishes the pledge.

6. Dispossession need not always require physical removal of the encumbered assets from the debtor's premises, provided that the debtor's access to them is excluded in other ways. This can be achieved, for example, by handing over the keys to the rooms in which the encumbered assets are stored to the secured creditor, provided that this excludes any unauthorized access by the debtor.

7. The debtor's dispossession can also be effected by delivering the encumbered assets to, or by using assets that are already held by, a third party. Examples are merchandise or raw materials stored in a warehouse or a tank of a third party. An institutional (and more expensive) arrangement may be involving an independent "warehousing" company, which exercises control over the pledged assets as agent for the secured creditor. For this arrangement to be valid, there cannot be any unauthorized access by the debtor to the rooms in which the pledged assets are stored. In addition, the warehousing company's employees must not work for the debtor (if they are drawn from the debtor's workforce, because of their expertise, they may no longer work for the debtor).

8. In the case of assets of a special nature, such as documents and instruments (whether or not negotiable), that embody rights in tangible assets (e.g. bills of lading or warehouse receipts) or intangible rights (e.g. negotiable instruments, bonds or share certificates), dispossession is effected by transferring the documents or instruments to the secured creditor. However, in this context, the line between possessory and non-possessory security may not always be easy to draw.

9. In view of the debtor's dispossession, the possessory pledge presents three important advantages for the secured creditor. First, the debtor is unable to dispose of the pledged assets without the secured creditor's consent. Second, the creditor does not run the risk that the actual value of the encumbered assets will be reduced through the debtor neglecting upkeep and maintenance. Third, if enforcement becomes necessary, the secured creditor is saved the trouble, time, expense and risk of having to claim delivery of the encumbered assets from the debtor.

10. Possessory security has also advantages for third parties, especially the debtor's other creditors. The required dispossession of the debtor avoids any risk of creating a wrong impression of wealth and also minimizes the risk of fraud.

11. On the other hand, the possessory pledge has also major disadvantages. The greatest disadvantage for the debtor is the required dispossession, which precludes the debtor from using the encumbered assets. Dispossession is particularly troublesome in situations where possession of the encumbered assets is indispensable for commercial debtors who require these assets to generate the income from which to repay the loan (as is the case, for example, with raw materials, semi-finished goods, equipment and inventory).

12. For the secured creditor, the possessory pledge has the disadvantage that it has to store, preserve and maintain the encumbered assets, unless a third party assumes this task. Where secured creditors themselves are neither able nor willing to assume these tasks, entrusting third parties will involve additional costs that will be directly or indirectly borne by the debtor. Another disadvantage is the potential liability of the secured creditor in possession of encumbered assets (e.g. pledgee, holder of a

warehouse warrant or a bill of lading) that might have caused damage. This is a particularly serious problem in the case of liability for contamination of the environment, since often the monetary consequences (cleanup, damages) substantially exceed the value of the encumbered asset, let alone the prejudice to the reputation and image of the lender. Very few laws address environmental liability of secured creditors in possession. Some of them expressly exempt secured creditors from liability. Other laws limit such liability under certain conditions. When no such exemption from or limitation of liability exists, the risk may be too high for a lender to accept to extend credit or, at least, require insurance, which to the extent it is available, will significantly increase the cost of the transaction to the debtor.

[Note to the Working Group: The Working Group may wish to define the limits of secured creditors' liability and establish safe harbours for creditors in connection with their entering into possession of encumbered assets to protect their security right, whether when taking a possessory security or upon enforcement of a non-possessory security.]

13. However, where the parties are able to avoid the aforementioned disadvantages (see paras. 11-12), the possessory pledge can be utilized successfully. There are two major fields of application. First, where the encumbered assets are already held by or can easily be brought into the possession of a third party, especially a commercial keeper of other persons' assets. The second field of application is where instruments and documents, embodying tangible assets or intangible rights, can be easily kept by the secured creditor itself.

(b) Right of retention of possession

14. Statutory rights of retention are not discussed since, with few exceptions, statutory rights are outside the scope of this Guide (see A/CN.9/WG.VI/WP.6/Add.1, para. 8). A right of retention created by agreement allows a party whose contractual partner is in breach of contract to withhold its own performance and, in particular, an asset which under the terms of the contract the withholding party is obliged to deliver to the party in breach. For example, a bank need not return securities it holds for its customer or allow withdrawals from the customer's bank account, if the customer is in default on repayment of a credit and had agreed to grant the bank a right of retention. Where such 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 pledge, although the method of its creation deviates from that of the pledge proper (see paras. 5-8). Alternatively, a reinforced right of retention may be regarded as having some of the effects of a pledge. The most important consequence of such an assimilation to a pledge is that the creditor in possession has a priority in the assets retained, unless they are subject to an earlier created and effective non-possessory security right.

ii. Non-possessory security

15. As noted above (see para. 11), a possessory pledge of tangibles required for production or sale (such as equipment, raw materials, semi-finished goods and inventory) is economically impractical. These goods are necessary for the entrepreneurial activity of commercial debtors. Without access to, and the right and power of disposition over those assets, the debtor would not be able to earn the

necessary income to repay the loan. This problem is particularly acute for the growing number of commercial debtors who do not own immovables that can be used as security.

16. To address this problem, laws, especially in the last fifty years, began providing for security in movable assets outside the narrow confines of the possessory pledge. While some countries introduced a new security right encompassing various arrangements serving security purposes, most countries, continuing the tradition of the nineteenth century but disregarding an earlier, more liberal attitude, insisted on the “pledge principle” as the only legitimate method of creating security in movable assets. The English common law “charge” was for some time the only genuine non-possessory security. In the twentieth century, legislators and courts have come to acknowledge the urgent economic need to provide security without recourse, and in addition, to the possessory pledge.

17. Individual countries attempted to find appropriate solutions according to particular local needs and in conformity with the general framework of their legal system. The result is a diverse range of solutions. An external indication of the existing diversity is the variety of names for the relevant institutions, sometimes differing even within a single country, such as: “fictive” dispossession of the debtor; non-possessory pledge; registered pledge; *nantissement*; warrant; *hypothèque*; “contractual privilege”; bill of sale; chattel mortgage; and trust. More relevant is the limited scope of application of the approaches taken. Only a few countries have enacted a general statute on non-possessory security (for a more comprehensive approach, see section A.4). Some countries have two sets of legislation, one dealing with security for financing of industrial and artisan enterprises, the other with security for financing of farming and fishing enterprises. In most countries, however, there is a variety of statutes covering only small economic sectors, such as the acquisition of cars or of machinery, or the production of films.

18. In some countries, there is even some reluctance to allow security rights in inventory. This is sometimes based upon an alleged inconsistency between the creditor’s security right and the debtor’s right and power to sell which is indispensable for converting the inventory to cash with which to repay a secured loan. Another objection is that the disposition of inventory will often give rise to difficult conflicts between multiple transferees or multiple secured creditors. Yet another possible objection may come from a policy decision to reserve inventory for the satisfaction of the claims of the debtor’s unsecured creditors (see A/CN.9/WG.VI/WP.6/Add.5, para. 26, note).

19. Varied as the legislation providing for non-possessory security might be, it shares one common feature, namely that some form of publicity of the security right is usually provided for. The purpose of publicity is to dispel the false impression of wealth which otherwise may be derived from the fact that the security right in assets held by the debtor is not apparent (for a detailed discussion of this matter, see A/CN.9/WG.VI/WP.6/Add.4, paras. ...). It is often argued that, in a modern credit economy, parties may assume that assets may be encumbered or may be subject to a retention of title. Such general assumptions, however, are bound to increase the cost of credit, even in cases where the person in possession is the owner and the assets are not encumbered (a risk that can be only partially avoided at the cost of an extensive and costly search). In addition, such assumptions fail to sufficiently protect the secured creditor or other third parties, since they do not reveal the name

of the owner or previous secured creditor, or the amount owed, and they do not provide information as to the asset encumbered. Furthermore, in such a system based on general assumptions, there is no objective basis for a priority system to rank security rights in the same assets and thus debtors may not be able to use the full value of their assets to obtain credit.

20. There appears to be a need to bridge the gap between the general economic demand for non-possessory security with the often limited access to such security under current law. A major purpose of legal reform in the area of secured transactions is to develop suggestions for improvement in the field of non-possessory security and in the related field of security in intangibles (see section A.2.b).

21. While modern regimes demonstrate that difficulties can be overcome, experience has shown that legislation on non-possessory security is more complicated than the regulation of the traditional possessory pledge. This is due mainly to the following four key characteristics of non-possessory security rights. First, since the debtor retains possession, it has the power to dispose of or create a competing right in the encumbered assets, even against the secured creditor's will. This situation necessitates the introduction of rules concerning the effects and priority of such dispositions (see A/CN.9/WG.VI/WP.2/Add.7 on priority). Second, the secured creditor must ensure that the debtor in possession takes proper care of, duly insures and protects the encumbered assets to preserve their commercial value, matters which must all be addressed in the security agreement between the secured creditor and the debtor (see A/CN.9/WG.VI/WP.2/Add.8 on rights and obligations of parties before default). Third, if enforcement of the security becomes necessary, the secured creditor will usually prefer to obtain the encumbered assets. However, if the debtor is not willing to part with those assets, court proceedings may have to be instituted. Proper remedies and possibly an accelerated proceeding may have to be provided for (see A/CN.9/WG.VI/WP.2/Add.9 on default and enforcement). Fourth, the appearance of false wealth in the debtor which is created by "secret" security rights in assets held by the debtor may have to be counteracted by various forms of publicity (see A/CN.9/WG.VI/WP.6/Add.4 on publicity).

22. In light of the generally recognized economic need for allowing non-possessory security and the basic differences between possessory and non-possessory security mentioned above (see para. 21), new legislation will be necessary in many countries. In order to meet this economic need and to promote certainty, such legislation should be uniform, comprehensive and consistent. Legislation that introduces non-possessory security by way of narrow and divergent exceptions to the traditional principle of the possessory pledge, as is the case with some countries, could not achieve this result and should be revised.

23. In view of earlier legislative models (see paras. 16-19), legislators may be faced with three alternatives. One alternative may be to adopt uniform legislation for both possessory and non-possessory security rights (see section A.4). This is the well-considered approach of the Model Inter-American Law on Secured Transactions, adopted in February 2002. Another alternative may be to adopt uniform legislation for non-possessory security rights, leaving the regime on possessory rights to other domestic law. Yet another alternative may be to adopt special legislation allowing non-possessory security for credit to debtors in specific branches of business. The prevailing trend of modern legislation, both at the

national and the international level, is towards a uniform approach at least as far as non-possessory security is concerned. A selective approach is likely to result in gaps, inconsistencies and lack of transparency, as well as in discontent in those sectors of the industry that might be excluded.

b. Security rights in intangible movable property

24. Intangibles comprise a broad variety of rights (e.g. right to the payment of money or the performance of other contractual obligation, such as the delivery of oil under a production contract). They include some relatively new types of asset (e.g. uncertificated securities, held indirectly through an intermediary) and intellectual property rights (i.e. patents, trade marks and copyrights). In view of the dramatic increase in the economic importance of intangibles in recent years, there is a growing demand to use these rights as assets for security. Intangibles, such as receivables and intellectual property rights, are often part of inventory or equipment financing transactions, and often the main value of the security is in those intangibles. Furthermore, intangibles may be proceeds of inventory or equipment. However, this Guide does not deal with securities, since they raise a whole range of issues requiring special treatment and these issues are addressed in texts being prepared by the International Institute for the Unification of Private Law (UNIDROIT) and the Hague Conference on Private International Law. Similarly, this Guide will not deal with security in intellectual property rights either because of their complex and specialized nature. The Guide does, however, discuss security in receivables, i.e. rights to claim payment of money, and rights to claim performance of non-monetary contractual obligations, as well as security in other types of intangibles as proceeds of tangibles or receivables.

25. By definition, intangibles are incapable of (physical) possession. Nevertheless, most codes of the so-called “civil law” countries have dealt with the creation of possessory pledges (see paras. 5-13) at least in monetary claims. Some codes have attempted to create the semblance of dispossession by requiring the debtor to transfer any writing or document relating to the pledged claim (such as the contract from which the claim was derived) to the creditor. However, such transfer does not suffice to constitute the pledge. Rather, the debtor’s “dispossession” is, in many countries, replaced (quite artificially) by requiring that a notice of the pledge be given to the debtor of the pledged claim.

26. In some countries, techniques have been developed that achieve ends comparable to those attained by the possession of tangibles. The most radical method is the full transfer of the encumbered right (or the encumbered share of it) to the secured creditor. However, this goes beyond creation of a security right and amounts to transfer of title (see section A.3.a). Under a more restrained approach, title to the encumbered rights is not affected but dispositions by the debtor that are not authorized by the secured creditor are blocked. This technique can be used where a person other than the person owing the performance in which the secured creditor’s right is created (the third-party debtor) has the power to dispose of the encumbered right. In the case of a bank account, if the debtor as holder of the account agrees that its account can be blocked in favour of the secured creditor, the latter has the equivalent of possession of a tangible movable. That is even more true if the bank itself is the secured creditor.

27. In modern terminology, such techniques of obtaining “possession” of intangible property are appropriately called “control”. The degree of control though may vary. In some cases, the control is absolute and any disposition by the debtor is prevented. In other cases, the debtor is allowed to make certain dispositions or dispositions up to a fixed maximum, as long as the secured creditor has access to the account. Control may be a condition for the validity of a security right (see A/CN.9/WG.VI/WP.6/Add.3, para. ...) or priority (see A/CN.9/WG.VI/WP.2/Add.7, para. 12).

28. In the context of efforts to create comprehensive regimes for non-possessory security in tangibles (see section A.2.a), it is common for security in the most important types of intangibles to be integrated into the same legal regime, especially in receivables. This serves consistency since the sale of inventory results, as a rule, in receivables and it is often desirable to extend the security in inventory to the resulting proceeds. The publicity system provided for security in tangibles can perform its salutary functions (for details, see A.CN.9/WG.VI/WP.6/Add.4 on publicity) for security in intangibles, such as receivables, as well. This may have the additional benefit of dispensing with notification of the debtor of receivables, which in certain security transactions involving a pool of assets that are not specifically identified may not be feasible. Even if such notification is feasible, in some legal systems, it may not be desirable (e.g. for reasons of cost or confidentiality).

3. The use of title for security purposes

29. In addition to instruments for security proper (see section A.2), practice and sometimes also legislation has in many countries developed an alternative approach for non-possessory security rights in both tangible and intangible assets, namely title (or ownership) as security (*propriété sûreté*). Title as security can be created either by transfer of title to the creditor (see section A.3.a) or by retention of title by the creditor (see section A.3.b). Both transfer and retention of title enable the creditor to obtain non-possessory security (for the economic need for, and justification of, non-possessory security, see para. 15).

a. Transfer of title to the creditor

30. In the absence of a regime of non-possessory security rights, or to fill gaps or address impediments, courts and legislators in some countries have taken recourse to transfer of title of the assets to the secured creditor.

31. There are two features that make the security transfer of title attractive for creditors in certain jurisdictions. First, the formal and substantive requirements for transferring title in tangibles or intangibles to another person are often less onerous than the requirements for creating a security right. Second, in the case of enforcement and in the debtor’s insolvency, a creditor often has a better position as an owner than as a holder of a mere security right, especially where the owner’s assets, although in the debtor’s possession, do not belong to the insolvency estate whereas the debtor’s assets, if merely encumbered by a security right for the creditor, do belong to the estate. In other jurisdictions though there is no difference between title for security purposes and security rights with respect to the requirements for creation or enforcement.

32. The security transfer of title has been allowed by law in some countries and by court practice in other countries. In many other countries, especially from the civil law world, such transfers of title are regarded as a circumvention of the ordinary regime of security instruments proper and are therefore held to be void. Some countries, while allowing a security transfer of title, compromise by reducing its effect to that of an ordinary security, especially where it competes with other creditors of the debtor.

33. Legislators are faced with two policy options. One option is to admit security transfers of title with the (usually) reduced requirements and the greater effects of a full transfer, thus avoiding the general regime for security rights. The other option is to admit security transfers of title, but to limit either the requirements or the effects or both to those of a mere security right. The first option results in enhancing the secured creditor's position (although at the risk of increasing the liability of the creditor, see para. 12), while weakening the position of the debtor and the debtor's other creditors. This solution may make sense if the ordinary security regime for debtor-held security is underdeveloped. Under the second option, a graduated reduction of the secured creditor's advantages and of the other parties' corresponding disadvantages is possible, especially if the requirements of a transfer or its effects or both are limited to those relating to a security right. Any variant of this solution may also counter specific weaknesses of the ordinary regime for non-possessory security. However, generally speaking, in countries with a modern, comprehensive and workable regime for non-possessory security, there is no need for allowing transfer of title as a security device. Further, the system of a uniform comprehensive security (see section G) integrates transfers of title by regarding them as security rights.

b. Retention of title by the creditor

34. The second method of using title as security is by contractual retention of title (reservation of ownership). The seller or other lender of the money necessary to purchase tangible or even intangible assets may retain title until full payment of the purchase price (simple retention of title or "ROT" arrangement). This type of transaction is often called "purchase money financing", (see description and example in A/CN.9/WG.VI/WP.6/Add.1, paras. 16-19).

35. There are several variations of ROT arrangements, including: "all monies" or "current account" clauses, in which the seller retains title until all debts owing from the buyer have been discharged and not just those arising from the particular contract of sale; and proceeds and products clauses, in which title extends to the proceeds and the products of the assets in which the seller retained title. An alternative to a retention of title arrangement with the same economic result is achieved by combining a lease contract with an option to purchase for the lessee (for a nominal value), which may only be exercised after the lessee has paid most of the "purchase price" through rent instalments (see example in A/CN.9/WG.VI/WP.6/Add.1, para. 20). In some cases, where the lease covers the useful life of equipment, it is equivalent to a retention of title arrangement even without an option to buy.

36. Economically, a retention of title arrangement provides a security right which is particularly well adapted to the needs of, and therefore is widely used by, sellers for securing purchase money credit. In many countries, this kind of credit is widely

used as an alternative to bank financing that is not purchase money financing and is given preferential status in view of the importance of small- and medium-size suppliers for the economy. In other countries, banks also provide on a more regular basis purchase money financing, for example, where the seller sells to a bank and the bank sells to buyer with a retention of title or where the buyer pays the seller in cash from a loan and transfers title to the bank as security for the loan. In those countries, this source of credit and its attendant specific security is given special attention.

37. Due to its origin as a term of a contract of sale or lease, many countries regard the retention of title arrangement as a mere quasi-security, and, therefore, not subject to the general rules on security, such as requirements of form, publicity or effects (principally priority). Contrary to the transfer of title, its retention by the creditor has, in many countries, a privileged status. This may be justified by the desire to support normally small- and medium-size suppliers and to promote purchase money financing by suppliers as an alternative to bank credit that is not purchase money financing. This privileged status may also be justified by the fact that the seller, by parting with the sold goods without having received payment, increases the debtor's pool of assets and requires protection.

38. In contrast, a number of jurisdictions do not recognize retention of title clauses, while a number of other jurisdictions even prohibit them. Other countries restrict the scope of application of such clauses by denying them effect with respect 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 of disposition over the inventory.

39. Several policy options may be considered. One option is to preserve the special character of the retention of title arrangement as a title device. Another option might be to limit the effect of the retention of title arrangement to: only the purchase price of the respective asset to the exclusion of any other credit; and/or to the purchased asset to the exclusion of proceeds or products. Yet another option might be to integrate the retention of title arrangement into the ordinary system of security rights. In such a case, one may consider granting certain advantages to the seller-creditor for the policy reasons mentioned above (see para. 36). Yet another option might be to place the retention of title fully on a par with any other non-possessory security.

40. The first two options would preserve or even create a special regime outside a comprehensive system of non-possessory security rights. In particular, the first option provides the seller-creditor with extensive privileges, a result that has consequential disadvantages for competing creditors of the buyer, especially in the case of execution and insolvency. A technical disadvantage of the title approach is that it prevents or at least impedes the buyer from using the purchased assets for granting a second-ranking security to another creditor. Another disadvantage of the title approach is that executions by the buyer's other creditors are impossible or difficult without the seller's consent.

41. The last two options mentioned above (see para. 39) are more in line with a comprehensive system of security rights. These options accept that the seller extending credit deserves a certain privileged position since it parts with the sold goods on credit and purchase money credit should be promoted for economic

reasons. On the other hand, in the interest of competing creditors, the statutory privilege is limited to the purchase price for the specific asset and to the sold goods as such. By contrast, rights in proceeds or products of the purchased goods, or sums owing from the debtor-buyer other than those arising from the particular contract of sale with an ROT clause, do not enjoy such a privilege and are subject to the rules applicable to ordinary security rights (e.g. have priority as of the time the relevant transaction is registered).

42. Converting retention of title to a security right would enhance the position of the buyer-debtor since it would be enabled to create a second-ranking (non-possessory) security right to secure a loan from another creditor. It could also improve the position of other creditors of the buyer-debtor in the case of execution with respect to the encumbered asset and in the case of the debtor's insolvency. The supplier's position would not necessarily be weakened, since: with a few exceptions, in principle only simple ROT clauses enjoy a privileged position; and whether or not the retention of title is assimilated to a security right, the assets subject to it are not necessarily part of the debtor's estate (see A/CN.9/WG.VI/WP.6/Add.5, para. 12). However, the supplier would need to register (see A/CN.9/WG.VI/WP.2/Add.7, para. 23), and "all sums" clauses, proceeds and products would enjoy priority only as of the time of registration.

4. Uniform comprehensive security

43. The idea of a single, uniform, comprehensive security right in all types of assets was first developed in the United States of America in the middle of the twentieth century in the context of the Uniform Commercial Code ("UCC"). The UCC, a model law adopted by all fifty states, created a single, comprehensive security right in movables. Article 9 of the UCC unified numerous and diverse possessory and non-possessory rights in tangibles and intangibles, including transfer and retention of title arrangements, that existed under state statutes and common law. The idea spread to Canada, New Zealand and a few other countries. It is recommended in the Model Law of the European Bank for Reconstruction and Development. The Inter-American Model Law on Secured Transactions follows in many respects a similar approach.

44. Technically, two approaches can be used to achieve a uniform and comprehensive security right. Under one approach, the names of the old security devices are preserved and can be used, such as (possessory) pledge and transfer of title. However, their creation and effects are made subject to one unified set of rules. Under a slightly different approach, a new, comprehensive security right is created. In the end, though, there is no substantive difference between the two approaches.

45. The main feature of a broad approach is that it merges the rules for the traditional possessory pledge with the rules on non-possessory pledge and transfer or retention of title for security purposes. This approach results in the creation of a single and comprehensive security right system, ensuring consistent treatment of different types of security rights. This is to the benefit of debtors, secured creditors and third parties, including the insolvency representative in the debtor's insolvency (or the grantor's insolvency if the debtor and the grantor are two different persons). A creditor who envisages granting a secured loan, need not investigate various alternative security devices and evaluate their respective prerequisites and limits as well as advantages and disadvantages. Correspondingly, the burden borne by the

debtor's creditors or the insolvency representative for the debtor who 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 rather than several different regimes. Further, this will reduce the cost of creating security and, concomitantly, the cost of the secured credit.

46. In cross-border situations, the recognition of security rights created in another jurisdiction will also be facilitated if the jurisdiction of the new location of encumbered assets has a comprehensive security right. Such a system can much more easily accept a broad variety of foreign security rights, whether of a narrow or an equally comprehensive character.

47. The basic approach does not prevent a legislature from adjusting the contents of the individual provisions implementing so as to reflect its particular policies. For example, within this unitary system, special interests (e.g. for purchase money security) may be addressed by means of priority rules (see A/CN.9/WG.VI/WP.2/Add.7, paras. 19-24).

B. Summary and recommendations

48. In certain, albeit limited, practical situations, the possessory pledge functions usefully as a strong security right (see para. 13).

[Note to the Working Group: The Working Group may wish to consider recommending to States to include in their secured transactions laws or in their environmental laws a rule exempting the secured creditor from liability (or limiting such liability under certain conditions) that may arise from the secured creditor obtaining possession of encumbered assets in the case of possessory pledges. The same exemption (or limitation of liability) could also apply to creditors with a non-possessory security right seeking to enforce their security right upon default, including when engaging, prior to enforcement, in workout activities involving the encumbered assets or the facility where the encumbered assets are stored. Such an exemption or limitation of liability may be limited to secured creditors that have not operated, managed or exercised decision-making control over the facility where the encumbered assets are located.]

49. A right of retention of possession created by agreement, if accompanied by the creditor's power of sale, functions as a possessory pledge (see para. 14).

[Note to the Working Group: The Working Group may wish to consider subjecting such a right of retention to the same rules that govern possessory pledges, perhaps with the exception of the rules governing the creation of such rights of retention.]

50. Non-possessory security rights are of utmost importance for a modern and efficient regime of secured transactions. Debtors need to retain possession of encumbered assets and secured creditors need to be protected against competing claims in the case of debtor default and in particular insolvency (see para. 15).

51. In light of the growing importance of intangibles as security for credit, and the often insufficient rules applicable to this type of security, it would be desirable to

develop a modern legal regime for security in intangibles, especially for receivables (see para. 28).

[Note to the Working Group: To ensure consistency, the Working Group may wish to consider that a regime for security rights in certain types of intangibles should be as close as possible to that for non-possessory security in tangibles.]

The Working Group may also wish to discuss the conclusions to be arrived at in the Guide with respect to particular types of intangibles, such as receivables. In its discussion of this matter, the Working Group may wish to take into account: other work of UNCITRAL and work of other organizations; the fact that intangibles may be taken as security in the context of transactions relating to security in tangibles (e.g. inventory or equipment financing) or may be proceeds of tangibles; and the complexity and feasibility of a regime on security rights in intangibles.]

52. The transfer of title for security purposes does not appear to be useful where there is an efficient and effective regime of non-possessory security in tangible and intangible assets (see para. 33).

53. If the retention of title (or reservation of ownership) is treated as a mere security device, the seller-creditor or other provider of purchase money should be conferred a special priority equivalent to that of a holder of title.

[Note to the Working Group: The Working Group may wish to consider whether such a special priority should be limited to the sold asset and/or to its outstanding purchase price (to the exclusion of proceeds and products, as well as of other sums owing from the debtor, see para. 40). The Working Group may also wish to consider that treating the retention of title as equivalent to an "ordinary" security right should not prejudice its qualification for other purposes (e.g. taxation, accounting, etc.).]

54. There are good reasons for replacing a regime of security rights consisting of a variety of specific security devices by a general, comprehensive security right (see paras. 45-47).

[Note to the Working Group: The Working Group may wish to consider the advantages and disadvantages of the approach taken in several modern security laws that introduce a uniform comprehensive security right (see paras. 43-47).]

General AssemblyDistr.: Limited
5 November 2002*

Original: English

**United Nations Commission
on International Trade Law**
Working Group VI (Security Interests)
Second session
Vienna, 17-20 December 2002**Security Interests
Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-75	1
IV. Creation	1-75	2
A. General remarks	1-70	2
1. Introduction	1-3	2
2. Basic elements of a security right	4-47	2
a. Obligations to be secured	4-15	2
b. Assets to be encumbered	16-35	5
c. Proceeds	36-47	10
3. Security agreement	48-60	12
a. Definition and functions	48-50	12
b. Parties	51	13
c. Minimum contents	52-53	13
d. Formalities	54-58	13
e. Effects	59-60	14
4. Proprietary requirements	61-70	15
a. Ownership or right of disposition of grantor	61-65	15
b. Transfer of possession, control, notification, publicity	66-70	16
B. Summary and recommendations	71-75	17

* This document is submitted four weeks later than the required ten weeks prior to the start of the meeting because of the need to complete consultations and to finalize consequent amendments.

IV. Creation

A. General remarks

1. Introduction

1. This Chapter deals with issues relating to the contractual basis for creating a security right (statutory or judicial security rights are only mentioned in the context of conflicts of priority; see A/CN.9/WG.VI/WP.2/Add.7, paras. 33-39). As the agreement of the parties alone is usually not sufficient to create a security right, this Chapter also discusses the additional, proprietary requirements, such as transfer of possession, notification, publicity or control. Before dealing with the issues relating to the security agreement (see section A.3) and the additional requirements for the creation of an effective security right (see section A.4), this Guide outlines the two basic elements of both, namely the obligations to be secured (see section A.2.a) and the assets to be encumbered (see section A.2.b)

2. The time of the conclusion of the security agreement or of the completion of an additional act is important for ranking security rights in the same asset (for the conditions and effects of ranking, see A/CN.9/WG.VI/WP.2/Add.7). As distinct from ownership, which, in principle, does not allow ranking of several owners, several security rights may be ranked and thus coexist in the same asset. The co-existence of several security rights in the same asset enables the debtor or other grantor to make full use of the economic value of the asset.

3. Even if a security right has been validly created, it may nevertheless fail to fulfil its most important function, i.e. to ensure priority in the case of the debtor's insolvency. This may occur, for example, where the creation of the security right contravenes prohibitions of insolvency law against preferential transfers made in the suspect period preceding the opening of an insolvency proceeding or contravenes applicable fraudulent transfer laws (for details, see A/CN.9/WG.VI/WP.6/Add.5).

2. Basic elements of a security right

a. Obligations to be secured

i. Connection between security and secured obligation

4. Security rights are accessory to, or dependent upon, the secured obligation. This means that the validity and the terms of the security agreement depend on the validity and the terms of the agreement giving rise to the secured obligation. In particular, the terms of the security right (e.g. the amount of the claim) cannot surpass the terms of the secured obligation (but they may be reduced if the parties agree). In order to accommodate modern financing practices (e.g. revolving loan facilities), the secured obligation does not need to be specific but can

encompass future obligations and fluctuating obligations (see paras. 9-15). In countries where retention of title is not assimilated to a security right, the principle of the accessory character of the security right does not govern title-based security rights (see A/CN.9/WG.VI/WP.6/Add.2, paras. 29-42). In such cases, the creditor's position is stronger since it does not need to prove the outstanding amount of the secured obligation in order to enforce its claim. However, the debtor may require the creditor to return any surplus obtained over the debtor's indebtedness.

ii. Limitations

5. In some countries, non-possessory security may relate only to specific types of obligations described in legislation (e.g. loans for the purchase of automobiles or loans to farmers). In other countries with a general regime for possessory only or also for non-possessory security rights, no such limitations exist. Such a comprehensive approach has the potential of spreading the main benefits from secured financing (i.e. greater availability of credit and at a lower cost) to the parties to a wide range of transactions. To the extent that no such limitations or distinctions of secured obligations are introduced, this approach may also enhance certainty.

6. In order to ensure certainty, consistency and equal treatment of all debtors and secured creditors, special regimes applicable to various types of obligations should be avoided to the extent possible. In situations where such special regimes are necessary for special socio-economic reasons, they should be specifically established by national legislators and not be prescribed for a broad variety of obligations. Such a specific regime may relate, for example, to obligations for payment of purchase money secured with a retention of title, which is generally given priority because of the importance of supplier or other purchase money credit for the economy (see A/CN.9/WG.VI/WP.6/Add.2, para. 36 and A/CN.9/WG.VI/WP.6/Add.5, para. 12).

iii. Varieties of obligations

(a) Monetary and non-monetary obligations

7. Following the example of most national laws, the regime envisaged in the Guide is based on the assumption that, in practice, the most important type of secured obligations is monetary obligations. At the same time, the Guide takes into account the widely recognised need to allow security for the performance of non-monetary obligations (e.g. for delivery of goods). However, in order to be enforceable against the encumbered asset, non-monetary obligations should be convertible to monetary obligations by the time of enforcement.

(b) Type of monetary obligation

8. It is neither possible nor necessary to list in legislation the potential sources of monetary obligations that can be secured. There is a wide range of potential sources and, in any case, the legal source is

irrelevant, unless there is a special regime for security rights in specific types of obligations (e.g. for loans by pawnbrokers). An indicative list of such monetary obligations would typically include obligations arising from loans and the purchase of goods, including inventory and equipment, on credit.

(c) Future obligations

9. Legal systems may differ on the distinction between “present” and “future” obligations. In some systems, an obligation is future if it is not due. In other systems, it is future if the contract from which it may arise has not been concluded at the time it is transferred or encumbered (see article 5 (b) of the United Nations Convention on the Assignment of Receivables in International Trade; “the United Nations Assignment Convention”). The former approach is aimed at enhancing certainty and debtor protection, while the latter approach, in the interest of the economy as a whole, is aimed at validating transactions relating to future obligations. Such transactions securing future obligations are of great economic importance (e.g. revolving loan transactions; see A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23). If each extension or increase of credit were to require that the corresponding security right be modified or even newly created, this could have a negative impact on the availability and the cost of credit.

10. For this reason, modern legal systems recognize security for future obligations. The potential inconsistency with the principle of the accessory character of security rights (see para. 4) is more apparent than real, since, while the security right may be created before, it cannot be enforced until the secured obligation actually arises. In some jurisdictions, in order to protect debtors from over-indebtedness, future obligations may be secured up to a maximum amount. A potential disadvantage of such an approach is that it may not be possible for the debtor to benefit from certain transactions, such as revolving loan facilities (see also para. 13).

11. Obligations subject to a condition subsequent are present obligations and, therefore, do not raise particular issues. Obligations subject to a condition precedent are normally treated like future obligations (see paras. 9-10).

iv. Description

(a) General

12. While a specific description of each secured obligation is usually not necessary, the secured obligation must be determined or determinable on the basis of the security agreement whenever a determination is needed. Such determination is needed, for example, upon enforcement by the secured creditor or upon execution by another creditor of the debtor.

(b) Maximum amount

13. In some legal systems, it is necessary for the parties to describe in specific terms the secured obligation in their agreement or to set a maximum limit to it. The assumption is that such description or limit is in the interest of the debtor since it would be protected from over-indebtedness and would have the option of obtaining additional credit from another party. However, such requirements may inadvertently result in limiting the amount of credit available and thereby in increasing the cost of credit. This is the main reason why many legal systems do not require specific descriptions and allow “all sums” clauses or, at least, do not set maximum limits for secured obligations (see also paras. 10 and 14). This approach is based on the assumption that the secured creditor cannot claim more than it is owed and that, if the obligation is fully secured, better credit terms are likely to be offered to the debtor (see also A/CN.9/WG.VI/WP.2/Add.5, paras. 35-37 and A/CN.9/WG.VI/WP.2/Add.6, paras. 11-12).

(c) Fluctuating amounts

14. As already noted (see para. 9 and A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23), modern financing transactions often no longer involve a one-time payment but frequently foresee advances being made at different points of time depending on the needs of the debtor. Such financing may be conducted by a current account, the balance of which fluctuates daily. If the amount of the secured obligation were to be reduced by each payment made (in line with the principle of the accessory nature of security), lenders would be discouraged from making further advances unless they were granted additional security. The law should, therefore, validate rights securing future advances.

(f) Amounts in foreign currency

15. The amount of the secured obligation may be expressed in any currency. Occasionally, difficulties of conversion into the currency of the place of payment, execution or insolvency may arise. This matter may be left to the agreement of the parties. However, in the interest of certainty, a secured transactions law should provide that, in the absence of an agreement, the amount of the secured obligation should be converted into the domestic currency.

b. Assets to be encumbered**i. Object of the security right**

16. The object of the security right is the debtor’s or (in cases where security is provided by a third party) the grantor’s ownership (title) in the encumbered asset (including future assets; see para. 61). In the case of a security right in a receivable, it is the grantor’s title in the receivable that is being encumbered. However, it is also possible to encumber a limited proprietary right, such as a right of use or a lease. In such cases, the

secured creditor's rights are as limited as the encumbered right of use or lease and are subject to any overriding rights of the owner.

ii. Limitations

17. As in the case of special regimes for certain types of secured obligations (see para. 5), special laws for specific types of non-possessory security rights introduce limitations as to the types of asset that may serve as security. Assets that may not be encumbered at all or may be encumbered only subject to limitations (e.g. a minimum value that may not be encumbered), may include, for example, wages, pensions and essential household goods (except as security for obligations to pay their purchase price).

18. In the absence of a public policy reason for such special regimes, it should be possible to create a security right in all types of asset, tangible or intangible, such as receivables and other rights, including counter-claims of debtors against secured creditors.

iii. Future assets

19. The issue of whether future assets may be encumbered is of great practical importance. The term "future" covers assets that already exist at the time of the conclusion of the security agreement but do not belong to the debtor (or the debtor cannot dispose of them). It also covers assets that, at that point of time, do not even exist. In both cases, it is assumed that the assets can be encumbered.

20. In many countries, the parties may agree to create a security right in a future asset of the debtor. The disposition is a present one but it becomes effective only when the debtor becomes the owner of the asset or becomes otherwise entitled to dispose of it. The United Nations Assignment Convention takes this approach (see art. 8 (2) and art. 2 (a)).

21. Permitting the use of future assets as security for credit is important, in particular, for securing claims arising under revolving loan transactions (see paras. 9-10) 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, successive acts of creating new security rights would be necessary, a result that could increase transaction costs.

22. In some countries, future assets may not be used as security. This approach is partly based upon technical notions of property law (what does not exist cannot be transferred or encumbered). Another reason is the concern that allowing broad dispositions of future assets may inadvertently result in over-indebtedness and in making the debtor excessively dependent on one creditor, preventing the debtor from obtaining additional secured credit from other sources (see para. 26). Yet

another reason for not permitting the creation of security rights in future assets is that the possibility that unsecured creditors of the debtor will obtain satisfaction for their claims may be significantly reduced.

23. 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 debtors can protect their own interests and do not need statutory limitations on the transferability of future assets. Moreover, unsecured creditors could be protected by appropriate rules of priority. Such rules could provide, for example, that, in the case of a conflict of priority between a secured creditor with a security right in all assets of a debtor and unsecured creditors, a certain part of the debtor's assets may be kept aside for the satisfaction of unsecured creditors (see paras. 26 and 32, as well as A/CN.9/WG.VI/WP.6/Add.5, paras. 26-28).

iv. Assets not specifically identified

24. Some types of asset, especially equipment, are stable and not subject to frequent dispositions and replacement. They can, therefore, be individually described and identified. Such specific identification, however, may not be possible for other types of asset, especially inventory and, to some degree, receivables. To address this problem, many countries have developed rules that allow the parties to describe only in general terms the assets to be encumbered. The specific identification, generally required, is transposed from the individual items to an aggregate, which in turn has to be specifically identified. For example, in the case of receivables, it may be sufficient to identify them by referring to "all debtors with initials A to G". In the case of inventory, a sufficient identification may be "all assets stored in the debtor's business premises room A".

25. In some legal systems, even a description referring to all assets, present and future, is sufficient (e.g. "all my assets, presently owned and after acquired"). In some of these legal systems, such an all-assets security is not allowed with respect to consumers or even to individual small traders.

26. Related to, though distinguishable from, the all-assets security is the issue of over-collateralization, which arises in situations where the value of the security significantly exceeds the amount of the secured obligation. While the secured creditor cannot claim more than its secured claim plus interest and expenses (and perhaps damages), over-collateralization may create problems. The debtor's assets may be encumbered to an extent that makes it difficult or even impossible for the debtor to obtain a second-ranking security from another creditor. In addition, executions by the debtor's unsecured creditors may be precluded or at least be made more difficult. Title-based security rights present the same problem. A solution developed by courts in some countries is to declare any excess security void or to grant the debtor a claim for release of such excess security (see paras. 23 and 32, as well as A/CN.9/WG.VI/WP.6/Add.5, paras. 26-28). This solution could work in

practice, provided that a commercially adequate margin is granted to the secured creditor.

v. Enterprise mortgages and floating charges

27. In some countries, all-assets security takes the form of enterprise mortgages or floating charges. One type of such mortgage is a small enterprise mortgage, which is essentially limited to intangibles such as trade names, the clientele or intellectual property rights (see article 69 of the OHADA Uniform Act). Due to its limited scope, this mortgage is of limited importance.

28. By contrast, the large enterprise mortgage plays a major role as security in some countries. A large enterprise mortgage may comprise all movable assets of an enterprise, whether tangible or intangible, although it may be limited to divisible parts of an enterprise. Usually, it does not comprise immovables, since they are subject to a distinct regime (as to fixtures, see paras. 34-35).

29. The most essential aspect of an enterprise mortgage is that the debtor-enterprise has the authority to dispose of its encumbered assets in the ordinary course of its business and that the security attaches automatically to the proceeds taking the place of the disposed assets. Under most legal systems, such an authority to dispose of encumbered assets is admissible without affecting the security right. However, in certain legal systems, dispositions of encumbered assets by the debtor, although authorized by the creditor, are regarded as irreconcilable with the idea of a security right. In some of these legal systems, the courts invented the idea of a “floating” charge, which is merely a potential property right with a license to the debtor-enterprise to dispose of the assets in the normal course of business. Dispositions are barred as of the time debtor is in default, when the floating charge “crystallizes” to become a fully effective “fixed” charge.

30. An interesting advantage of large enterprise mortgages is that upon enforcement by the secured creditor and upon execution by another creditor, an administrator can be appointed for the enterprise. This may assist in avoiding liquidation and in facilitating reorganisation of the enterprise with beneficial effects for creditors, the workforce and the economy in general. In practice, 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 by a court or other authority.

31. However, large enterprise mortgages present other disadvantages in practice. One disadvantage is that the secured creditor usually is or becomes the firm’s major or even exclusive credit provider. Although competition by another credit provider offering better terms is not necessarily precluded, such a situation is, in principle, undesirable. Another disadvantage is that, in practice, the holder of the mortgage often fails to sufficiently monitor the firm’s business activities and to

actively participate in reorganization proceedings since the mortgagee is amply secured.

32. In order to counterbalance the mortgagee's overly strong position, the debtor-enterprise may be given a claim for the release of grossly excessive security (see para. 26). Following the example of some countries, one may also consider mitigating the mortgagee's priority in the case of the enterprise's insolvency (see paras. 23 and 26, as well as A/CN.9/WG.VI/WP.6/Add.5, paras. 26-28).

33. In a modern secured transactions system, which allows security to be taken in all assets of a commercial debtor (whether incorporated or individual), the particular construction or the terminology of an "enterprise mortgage" or a "floating" need not be preserved. What is important is to preserve the functional characteristics of these devices. This means that a non-possessory security right in all assets of a debtor could be created and that the debtor could be given a right to dispose of the encumbered assets in the ordinary course of its business.

[Note to the Working Group: The Working Group may wish to consider whether, in the case of enforcement of a security right in all assets of a debtor, an administrator by a court or other authority could be appointed.]

vi. Fixtures

34. Fixtures are movables, especially equipment, attached to immovable property. This attachment raises the question whether fixtures continue to be governed by the law governing movable property (and the rights in them are preserved) or they become subject to the law governing immovable property (and the rights in them are extinguished). In many countries, fixtures or attachments that may not be easily separated become subject to the law governing immovable property and any previous rights in such fixtures or attachments may be extinguished (whether holders of such rights have a right to be compensated is a separate question). The determination whether a fixture may be easily separated is made on the basis of criteria, such as technical difficulty or cost (compared to the value of the fixture).

35. In those countries, fixtures that may easily be separated from the immovable property to which they have been attached do not become subject to the rights in the immovable property, if the owner of the fixtures and the owner of the immovable are different persons. This rule applies to a supplier with a retention of title in fixtures (typically equipment) and should apply to other secured creditors providing money for the purchase of the encumbered assets ("purchase money secured creditors"). Otherwise, the rights of purchase money secured creditors would be expropriated and the owner or mortgagee of the immovable property would be unjustly enriched. Such an approach would not result in frustrating legitimate expectations of third parties, if retention of title arrangements with respect to such fixtures could be noted in the land register, which is already possible in many countries.

[Note to the Working Group: The Working Group may wish to extend to holders of security rights securing purchase money for fixtures the right to register rights in fixtures in the land registry. Such an approach would prevent both the “expropriation” of the creditor’s security rights in fixtures and the unjustified enrichment of the real estate mortgagee.]

c. Proceeds

i. Introduction

36. When encumbered assets are disposed of (or leased or licensed) during the time in which the indebtedness they secure is outstanding, the debtor typically receives, in exchange for those assets, cash, tangible property (e.g. goods or negotiable instruments) or intangible property (e.g. receivables or other rights). Such cash or other tangible or intangible property is referred to in many legal systems as “proceeds” of the encumbered assets. In some cases, the original encumbered assets may generate proceeds that generate other proceeds when the debtor sells, exchanges or otherwise disposes of the original proceeds in return for other property. Such proceeds are referred to as “proceeds of proceeds”.

37. In other situations, the encumbered asset may generate other property for the debtor even without a transaction occurring. Property generated in this way by encumbered assets is referred to in some legal systems as “civil” or “natural fruits”. Such property may include, for example, interest or dividends on financial assets, insurance proceeds, new-born animals and fruits or crops.

38. In some legal systems, civil or natural fruits and proceeds are clearly distinguished and made subject to different rules. The difficulty in identifying proceeds and the need to protect rights of third parties in proceeds is often cited to justify this approach. Other legal systems do not distinguish between civil or natural fruits and proceeds and subject both to the same rules. The difficulty in distinguishing between civil or natural fruits and proceeds, the fact that both civil or natural fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets are among the reasons mentioned to justify this approach.

39. A legal system governing security rights must address two distinct questions with respect to proceeds and civil or natural fruits (hereinafter referred to collectively as “proceeds”, unless otherwise indicated). The first issue is whether the secured creditor retains the security right if the encumbered asset is transferred from the debtor to another person in the transaction that generates the proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.2/Add.7, paras. 26-32).

40. The second issue concerns the creditor’s rights with respect to the proceeds. A legal system governing security rights should provide clear answers to a number of questions (see paras. 41-47).

ii. Existence of rights in proceeds

41. The justification for a right in proceeds lies in the fact that, if the secured creditor does not obtain such a right, its rights in the encumbered assets could be defeated or reduced by a disposition of those assets. If the security right were extinguished once the encumbered assets are transferred to another person, it would not adequately protect the secured creditor against default and thus its value as a source of credit would diminish. This result, which would have a negative impact on the availability and the cost of credit, would be the same even if the security right in the original encumbered assets were survive their disposition. The reason for this result lies in the possibility that a transfer of the encumbered assets may increase the difficulty in locating and obtaining possession, increase the cost of enforcement and reduce their value.

iii. Circumstances in which rights in proceeds may arise

42. A right in proceeds typically arises where the encumbered assets are disposed of (or leased or licensed). In systems that treat civil or natural fruits as proceeds, a right in such proceeds may arise even if no transaction takes place with respect to the encumbered assets (e.g. dividends arising from stocks).

iv. Personal or proprietary nature of rights in proceeds

43. If the secured creditor's right in proceeds is a proprietary right, the secured creditor will not suffer a loss by reason of a transaction or other event, since a proprietary right produces effects against third parties. On the other hand, granting the secured creditor a proprietary right in proceeds might result in frustrating legitimate expectations of parties who obtained security rights in those proceeds as original encumbered assets. However, in legal systems in which security rights are subject to filing, this matter may be easier to deal with. In such 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.

v. Extent and time of identification of proceeds

44. *[The Working Group may wish to discuss the extent to which and the time when proceeds must be identifiable as resulting from the encumbered assets].*

vi. Tracing of proceeds mingled with other assets

45. *[The Working Group may wish to discuss the issue of tracing of proceeds that have been intermingled with other assets].*

vii. Basis of the rights in proceeds

46. In some legal systems, the law extends security rights to proceeds of encumbered assets and to proceeds of proceeds through default rules

applicable in the absence of an agreement to the contrary. In other legal systems, such a statutory right in proceeds does not exist (for the reasons mentioned in para. 43), but parties may take security in all types of asset. In such systems, parties may be free to provide, for example, that security is created in inventory, receivables, negotiable instruments, securities and cash. In such a way, all these assets become original encumbered assets and not proceeds. In some of these legal systems, parties may extend by agreement certain quasi security rights (e.g. retention of title) to proceeds (see A/CN.9/WG.VI/WP.6/Add.2, paras. 34-42 and A/CN.9/WG.VI/WP.2/Add.7, paras. 51-59).

viii. Proceeds of proceeds

47. If there is a right in proceeds of encumbered assets, it should extend to proceeds of proceeds. If the secured creditor loses its right in the proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case of there were no rights in proceeds (see para. 41).

3. Security agreement

a. Definition and functions

48. The security agreement between the creditor and the debtor or, in cases where security is provided by a third party, the grantor is one of the constitutive elements of a security right. An additional act is required in most, but not all, countries (see Section A.4). In some countries, the security agreement, accompanied by an additional act, produces proprietary effects against all parties (*erga omnes*). In those countries, quasi security devices, such as retention-of-title arrangements, produce proprietary effects *erga omnes* as of the time of the conclusion of the relevant agreement, which may be even oral. In other countries, the security agreement has proprietary effects only between the parties (*inter partes*), third-party effects being subject to an additional act.

49. The security agreement should be distinguished from an agreement to create security in the future (e.g. if a credit is extended to the debtor). Such an agreement creates an obligation to create a security right, but has no proprietary consequences.

50. The security agreement fulfils several functions. First, in civil law countries it is the legal justification (*causa*) for granting the security right to the creditor. Second, the security agreement establishes the connection between the security right and the secured claim. Third, the security agreement generally regulates the relationship between the debtor (or a third party) as grantor of the security right in the encumbered assets and the secured creditor (for pre-default rights, see A/CN.9/WG.VI/WP.2/Add.8; for post-default rights, see and A/CN.9/WG.VI/WP.2/Add.9 and A/CN.9/WG.VI/WP.6/Add.5). While the security agreement may be a separate agreement, often it is contained in the underlying financing contract or other similar contract (e.g. contract of sale of goods on credit) between the debtor and the creditor.

b. Parties

51. In most cases, the security agreement is concluded between the debtor as grantor of the security right and the creditor as the secured party. Occasionally, if a third person grants the security for the benefit of the debtor, this person becomes a party to the agreement instead of the debtor. In the case of major loans granted by several creditors (especially in case of syndicated loans), a third party, acting as agent or trustee for the creditors, may hold security rights. None of these possible variations affects the substance of the security agreement.

c. Minimum contents

52. The security agreement should identify the parties and reasonably describe the obligation to be secured by the encumbered assets. Whether or not legislation lists these matters as the minimum contents of a security agreement, failure to deal with them in the security agreement may result in the security being null and void, unless the missing elements may be established through other means.

53. The parties may clarify in the security agreement additional matters, such as the duty of care on the part of the party in possession of the encumbered asset. In the absence of an agreement, default rules may apply to clarify the relationship between the parties (for pre-default issues, see A/CN.9/WG.VI/WP.2/Add.8; for post-default issues, see A/CN.9/WG.VI/WP.2/Add.9 and A/CN.9/WG.VI/WP.6/Add.5).

d. Formalities**i. Written form and related requirements**

54. Legal systems differ as to form requirements and their function. In particular with respect to written form, some legal systems require no writing at all while other legal systems require a simple writing, a signed writing or even a notarized writing or an equivalent court or other document (as is the case with enterprise mortgages). Normally, written form performs the function of a warning to the parties about the legal consequences of their agreement, of evidence of the agreement and of protection for third parties against fraudulent antedating of the security agreement.

55. Written form may also be a condition of validity (or effectiveness in the sense of producing proprietary effects) between the parties or a condition of enforceability as against third parties or of priority among competing claimants. It may also be a condition of obtaining possession of the encumbered assets or invoking a security agreement in the case of enforcement, execution or insolvency.

56. In some legal systems, a certification of the date by a public authority is required for possessory pledges, with the exception of small amount loans where proof even by way of witnesses is permitted. While

such certification may address the problem of fraudulent ante-dating, it may raise the time and cost required for a transaction.

57. In other legal systems, a certified date or authentication of the security agreement is required for various types of non-possessory security (see, for example, articles 65, 70, 94 and 101 of the OHADA Act). At least in one country, such certification is required instead of publicity by registration. Where, however, registration is necessary, an additional certification of the date of the security agreement may not be required.

58. In the interest of saving time and cost, mandatory form requirements need to be kept to a minimum. Written form does not appear necessary as a condition of the validity (or effectiveness in the sense of producing proprietary effects) of the security agreement between the parties. However, with respect to third parties, a written security agreement may usefully serve evidentiary purposes and prevent fraudulent antedating, at least with respect to non-possessory security rights. A simple writing (which would need not to be signed by both parties and would include modern means of communication) should be sufficient. For enterprise mortgages or cases where the security agreement can serve as sufficient title for execution (see para. 55), a more formal document may be necessary. Alternatively, in such a case, no writing may be required but the secured creditor will have to bear the burden of establishing the contents and the date of the security agreement.

e. Effects

59. In some countries, in which property rights are only those that can be asserted against all parties (*erga omnes*), a fully effective security only comes into being upon conclusion of the security agreement and completion of an additional act (delivery of possession, notification, registration or control; see paras. 61-70). There are two exceptions. In some countries, a retention-of-title clause is effective vis-à-vis third parties upon conclusion of the sales agreement in which it is contained. The other exception relates to an assignment of receivables by way of security, which in some countries is fully effective even without notification of the debtor of the receivable.

60. In other countries, a distinction is drawn between proprietary effects as between the parties to the security agreement and proprietary effects as against third parties. In those countries, the security comes already into existence upon conclusion of the security agreement (in writing) but only between the contracting parties (*inter partes*). An additional act is required for the security to take effect against third parties (see paras. 61-70).

4. Proprietary requirements

a. Ownership or right of disposition

61. In most legal systems, the grantor of the security (who normally is the debtor but may also be a third party) has to be the owner of the assets to be encumbered (see para. 16). In other legal systems, it is sufficient if the grantor has the power to dispose of the assets (but no ownership). With respect to future assets, it suffices if the grantor becomes the owner or obtains the power of disposition at a future time (see paras. 19-23).

62. Where the grantor does not have the ownership or the power to dispose of the assets, the question arises whether the secured creditor can nevertheless acquire the security right in good faith. In some legal systems, the creditor acquires the security right if the subjective good faith is supported by objective indicia of ownership. These elements include situations where the creditor has extended or is about to extend credit to the debtor, or the grantor is registered as the owner of the assets to be encumbered or holds them and transfers possession thereof to the creditor.

63. Legislation on this subject often addresses the related issue of the validity and the effectiveness of contractual restrictions on dispositions. In some countries, effect is given to such limitations in order to protect the interests of one or the other party to the agreement restricting dispositions. In other countries, no effect or only a limited effect is given to contractual restrictions of dispositions so as to preserve the grantor's freedom of disposition prevails, in particular if the person acquiring an asset is not aware of the contractual restriction.

64. The United Nations Assignment Convention takes a similar approach to support transferability of a receivable claim, which is in the interest of the economy as a whole. Under article 9 of the Convention, the assignment is effective despite a contractual restriction on assignment agreed upon between the assignor and the debtor. Mere knowledge of the existence of the restriction on the part of the assignee is not enough for the avoidance of the contract from which the assigned receivable arises. The effect of this provision is limited in two ways. First, its application is limited to trade receivables broadly defined; and second, the contractual restriction is effective as between the assignor and the debtor, and 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. However, this claim may not be raised against the assignee by way of set-off (see article 18, paragraph 3).

65. This approach promotes receivables financing transactions since it relieves the assignee (i.e. the secured creditor) of the burden of having to examine the contract from which the assigned claim arose, in order to ascertain whether transfer of the claim has been prohibited or made subject to conditions. Otherwise, lenders would have to examine potentially a large number of contracts which may be costly or even impossible (e.g. in the case of future receivables).

b. Transfer of possession, control, notification, publicity

66. The methods of producing proprietary effects as against third parties and, in those systems that allow the ranking of several security rights in the same assets, of establishing priority over competing claimants vary from country to country, and even within individual countries, according to the type of security right involved. There are four main methods of creating a security right that is effective as against all persons (and has priority over competing claimants).

i. Transfer of possession

67. The possessory pledge type of security right is created by agreement and transfer of possession of the asset to the creditor or to an agreed third person acting as the creditor's agent. In the case of a transfer of ownership for security purposes, possession may be fictitiously transferred to the creditor by way of an additional agreement of deposit or security. Such an agreement superimposes on the debtor's direct possession the creditor's indirect possession (*constitutum possessorium*). In the case of negotiable instruments, possession may also be transferred by delivery, with an endorsement, if necessary, under the rules governing negotiable instruments.

ii. Control

68. Security rights in certain intangibles (e.g. bank accounts) are created by agreement and transfer of control. Control may take the form of fictitious possession (e.g. if the bank has a security right in the debtor's account with the bank). It may also be reflected in the power of disposition (e.g. if the secured creditor, on the basis of an agreement with the debtor, can dispose of the debtor's account, without the debtor's further consent).

iii. Notification

69. Security rights in receivables may be created by agreement and notification of the debtor of the receivables. Such notification is regarded as an act of publicity. However, notification may not be a very effective way to publicize an assignment, since notification may be impossible (e.g. in the case of an assignment of future receivables) or very costly (e.g. in the case of a bulk assignment involving several debtors), or debtors may not provide any or accurate information to interested third parties.

iv. Publicity

70. Some form of publicity may be required in particular for the creation of non-possessory security rights in tangibles and intangibles. This publicity may take the form of registration of the security agreement and have constitutive effects. It may also take the form of registration of a limited amount of data and function as a warning to third parties about the potential existence of a security right and as a basis for establishing

priority among competing claimants (for details on the forms, functions and effects of publicity, see A/CN.9/WG.VI/WP.2/Add.5 and 6).

B. Summary and recommendations

71. In a modern secured credit law, it should be possible to secure all types of obligations, including future obligations and a fluctuating amount of obligations. It should also be possible to provide security in all types of asset, including assets of which the debtor may not own or have the power to dispose of, or which do not exist, at the time of creation of the security right.

[Note to the Working Group: The Working Group may wish to consider whether any exceptions to these rules should be introduced. In addition, the Working Group may wish to consider the comparative advantages and disadvantages of a regime where security can be taken over all assets of a debtor.]

72. The secured creditor should also be given a right in readily identifiable proceeds.

[Note to the Working Group: The Working Group may wish to consider the nature and the extent of the right in proceeds (see paras. 36-47).]

73. In principle, a security agreement creating a non-possessory security right should be in written form. No writing should be required for possessory security rights. Writing should include modern means of communications and need not be signed by both parties. It should identify the parties and reasonably describe the encumbered assets and the secured obligation. In situations where no formalities are required, the secured creditor should have the burden of proving both the terms of the security agreement and the date of creation of the security.

[Note to the Working Group: The Working Group may also wish to consider whether further exceptions to the written form rule should be introduced.]

74. An agreement between the secured creditor and the debtor (or other grantor) and transfer of possession of the encumbered asset to the secured creditor or to an agreed third party is necessary for the creation of a possessory security right.

75. An agreement (in written form; see para. 72) and some additional act (control, notification or publicity) should be sufficient for the creation of a non-possessory security right.

[Note to the Working Group: The Working Group may wish to consider whether any exceptions to this general rule should be introduced. The Working Group may also wish to consider whether a distinction should be made between a security right that is valid or

effective as between the parties thereto and a security right that is effective as against all third persons.]

General Assembly

Distr.: Limited
27 November 2002



Original: English

United Nations Commission on International Trade Law

Working Group VI (Security Interests)
Second session
Vienna, 17-20 December 2002

Security Interests Draft legislative guide on secured transactions

Note by the Secretariat

As Chapters V (Publicity) and VI (Filing system) may be usefully combined, the revised version of the new Chapter will be issued after the second session of the Working Group when the Working Group will have the opportunity to discuss Chapter VI.

General AssemblyDistr.: Limited
26 September 2002

Original: English

**United Nations Commission
on International Trade Law**

Working Group VI (Security Interests)

Second session

Vienna, 17-20 December 2002

First Joint session of Working Groups V

(Insolvency Law) and VI (Security Interests)

Vienna, 16-17 December 2002

Security Interests**Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

	<i>Paragraphs</i>	<i>Page</i>
IX. Insolvency	1-53	2
A. General remarks	1-45	2
1. Introduction	1-5	2
2. Key objectives	6-8	3
3. Security rights in insolvency proceedings	9-45	4
a. The inclusion of encumbered assets in the insolvency estate	9-15	4
b. Limitations on the enforcement of security rights	16-22	5
c. Participation of secured creditors in insolvency proceedings	23-24	7
d. The validity of security rights and avoidance actions	25	8
e. The relative priority of security rights	26-28	8
f. Post-commencement financing	29-35	9
g. Reorganization proceedings	36-41	10
h. Expedited reorganization proceedings	42-45	12
B. Summary and recommendations	46-53	13

IX. Insolvency

A. General remarks

1. Introduction

1. This Chapter examines the effects of insolvency proceedings on the enforcement rights of the secured creditor. It should be read together with the UNCITRAL Legislative Guide on Insolvency Law, which addresses the issues identified here in the broader context of insolvency law (see A/CN.9/WG.V/WP.63 and Addenda). Conflict of laws issues arising with respect to security rights in insolvency proceedings are discussed in Chapter X.

2. Secured transactions laws and insolvency laws have overlapping concerns and objectives. Both are concerned with debtor-creditor relations and both encourage credit discipline on the part of debtors. Although insolvency regimes typically have additional objectives, such as the preservation of viable enterprises in temporary financial difficulty, both regimes share a common objective of protecting the economic value of security rights. Effective regulation in either area will contribute to positive outcomes in the other. A secured transactions law, for example, may expand the availability of credit, thus facilitating the operation of a business and the avoidance of insolvency. A secured transactions law may also promote responsible behaviour on the part of both creditors and debtors by requiring creditors to monitor the ability of debtors to perform their obligations, thereby discouraging over-indebtedness and consequent insolvency. Moreover, a secured transactions law that provides for a public record of security rights will make it easier for an insolvency administrator to determine promptly the legal status of creditors who claim that obligations owed to them are secured.

3. Nevertheless, there are tensions where secured transactions and insolvency law intersect because of the different approaches taken to discharging debts or other obligations. A secured transactions regime seeks to ensure that the value of the encumbered assets protects the secured creditor when the obligations owed to the secured creditor are not satisfied, while an insolvency regime deals with circumstances where obligations owing to all creditors cannot be satisfied. In addition, the former regime focuses on effective enforcement rights of individual creditors to maximize the likelihood that the obligations owed are performed or their economic value realized. The latter regime, on the other hand, seeks to maximize the return to all creditors by preventing a race between creditors to enforce individually their rights against their common debtor. These tensions need to be considered by legislators because development or reform in one regime can impose unforeseen transaction and compliance costs on stakeholders of the other regime. For this reason, conflicts between the rights and obligations imposed by the different regimes governing secured transactions and insolvency should be identified and reconciled by a country in its law reform process.

4. Insolvency regimes generally provide for two main types of proceedings: liquidation (which involves the termination of the commercial business of the debtor, and the subsequent realisation and distribution of the insolvency debtor's assets), and reorganization (designed to maximize the value of assets, and returns to all creditors, by saving a business rather than terminating it). In a liquidation proceeding, the insolvency representative is entrusted with the task of gathering the insolvency debtor's assets, selling or otherwise disposing of them, and distributing

the proceeds to the debtor's creditors. To maximize the liquidation value of these assets, actions by individual creditors against the debtor are usually stayed initially and the representative may continue the debtor's business for a short time and may sell the business as a going concern rather than selling individual assets separately. In a reorganization proceeding, on the other hand, the objective of the proceeding is to continue the debtor's business as a going concern if economically feasible. Most insolvency laws providing for reorganization proceedings take as their premise that the value of the insolvent debtor's business as reorganized will provide a greater return to creditors than if the individual assets of the business were liquidated. Thus, a successful reorganization will capture for the creditors the premium of the business's going concern value over its liquidation value (see A/CN.9/WG.V/WP.63/Add. 12).

5. As a supplement to reorganization proceedings, expedited approaches are evolving that encourage prompt judicial confirmation in a formal reorganization proceeding of an agreement reached by the principal creditors or classes of creditor before an insolvency proceeding commences (e.g. reorganizations dealing only with certain classes of debt, such as financial debt). These approaches respond to the need to support economic stability by rapid adjustment of the claims of financial institutions and reduce the cost and delay of the reorganization proceedings (see paras 42-45).

2. Key objectives

6. Legislators revising existing security rights laws or introducing a new secured transactions regime should reconcile proposed legislation with existing or proposed insolvency laws. To implement broad economic and social policies (e.g. protecting workers or preserving supply markets), an insolvency regime may adopt rules that modify rights of secured creditors. This is most notable in regimes that provide for reorganization proceedings. For example, insolvency laws that provide for reorganization of an insolvent debtor's business will often permit the insolvency representative to continue to use encumbered assets in the business to be reorganized. Secured creditors will, however, factor in these potential limitations on their rights to enforce their security rights when making their decision to extend credit. Modifications of the secured creditors' rights will therefore come at the cost of restricting the economic benefits of an effective secured transactions regime. Any modification should therefore be based on articulated policies and the insolvency law should set out the modifications in clear and predictable terms.

7. As a general rule, the validity and relative priority of a security right should be recognized in an insolvency proceeding. If a security right is valid outside insolvency proceedings so that it is effective against third parties, the validity of the security right should be recognized in the insolvency proceeding. Similarly, if a security right has priority over the right of another creditor outside the insolvency proceeding, the commencement of an insolvency proceeding should not alter the relative priority of this security right.

8. Any limitation on the right of a secured creditor to enforce its security right without the secured creditor's consent should preserve as nearly as possible the economic value that a security right had outside the insolvency proceeding. An insolvency regime should therefore provide mechanisms that protect the economic value of the security right.

3. Security rights in insolvency proceedings

a. The inclusion of encumbered assets in the insolvency estate

9. An initial question is whether the secured creditor's security right is subject to insolvency proceedings or, in other words, whether the encumbered assets are part of the "estate" created when insolvency proceedings are commenced against a debtor (see A/CN.9/WG.V/WP.63/Add.5). The estate is comprised of those assets of an insolvent debtor that are subject to administration in and use during the insolvency proceeding.

10. Inclusion of encumbered assets within the insolvency estate can give rise to different effects. In many jurisdictions, inclusion in the estate will limit a secured creditor's ability to enforce its security right (see para. 16). Any such legislative limitations on commercial agreements will be taken into account by creditors when deciding whether to extend credit to a debtor, and at what cost. Some insolvency laws that require all assets to be subject to insolvency proceedings in the first instance allow the separation of encumbered assets from the estate where there is proof of harm or prejudice to the economic value of the security right or where the particular assets are shown to be fully encumbered and unnecessary to the reorganization process.

11. To allow for an assessment of whether the continuation of the proceedings will maximize the eventual return to creditors overall, an insolvency law may subject the encumbered assets to control within the insolvency proceedings. As a consequence, a secured creditor may be prohibited from taking possession of encumbered assets or, if it is in possession, may be required to surrender possession of the encumbered assets to the insolvency representative. This approach may be taken not only in reorganization proceedings, but also in liquidation proceedings in which the insolvent debtor's business is to continue while assets are liquidated in stages, or there is a likelihood that the business may be sold as a going concern. As it may not be possible to know at the commencement of insolvency proceedings whether it is desirable to continue the business, many insolvency regimes include the encumbered assets in the estate at least for a limited time period.

12. An insolvency estate will normally include all assets in which the insolvent debtor has a right at the time insolvency proceedings are commenced. In those jurisdictions where title of the encumbered assets is transferred to the creditor and this is treated as creating a security right (see Chapter III.A.3), the assets are treated as being part of the insolvency estate. The transfer of title to the creditor should, however, be distinguished from the retention of title by the supplier or other purchase-money financier of tangibles. Those jurisdictions that recognize the retention of title do not always include these tangibles within the insolvency estate, whether or not they otherwise assimilate the retention of title to security rights. A jurisdiction may, for example, wish to protect suppliers or other purchase-money financiers from the claims of other creditors when the assets and affairs of their common debtor are liquidated in an insolvency proceeding. Even these jurisdictions might not extend this exclusion to reorganization proceedings because of an overriding policy objective of continuing potentially viable businesses. In any event, this Guide recommends (see A/CN.9/WG.VI/WP.2/Add.5, paras. 11-14 and A/CN.9/WG.VI/WP.2/Add.7, paras. 23-24) that the secured transactions regimes in these jurisdictions should require the suppliers to publicize their interests so that non-purchase money creditors are informed of the suppliers' rights.

[Note to the Working Groups: The Working Groups may wish to consider whether (i) assets transferred to a secured creditor as security or assets in which title is retained by their seller or other purchase-money financier until full payment of the purchase money (see Chapter III, section A.3) and (ii) assets transferred to the insolvent debtor as security or assets sold by the insolvent debtor in which the insolvent debtor has retained title until full payment of their price should be part of the estate.]

13. Some secured creditors will participate in insolvency proceedings because they have both a secured and an unsecured claim. This is not limited to situations where the creditor has two separate obligations, only one of which is secured. It also occurs when the secured creditor is under-secured (i.e. the value of the encumbered assets is less than the amount of the secured obligation). In such a case, the secured creditor has a secured claim only to the extent of the value of the encumbered assets and an unsecured claim for the difference (see also section A.3.b).

14. An insolvency law should provide for the time and manner for determining the economic value of a security right. In principle, the value should be determined as of the time that the insolvency proceeding formally commences. The manner for determining the value will ordinarily be related to the procedure for the recognition of the validity of claims against the debtor's estate (for the variety of possible mechanisms for the admission of claims, including secured claims, see A/CN.9/WG.V/WP.63/Add.13).

15. Outside insolvency, a security agreement may provide that a security right includes the proceeds of encumbered assets and after-acquired assets. An insolvency law should address the issue of whether the secured creditor continues to be entitled to these proceeds and assets acquired after the commencement of insolvency proceedings. Proceeds received on the disposition of encumbered assets in effect are a substitute for those assets and should in principle secure the economic value of the security right. Proceeds in the form of fruits and products of encumbered assets are not literally substitutes but represent natural increases which all parties expect to be subject to the security right. To the extent, however, that the insolvency representative incurs expenses in connection with these proceeds, the secured creditor rather than the estate should ultimately bear the burden of these expenses. Assets acquired by the estate after the commencement of the insolvency proceedings in which the secured creditor might have a right outside insolvency are not substitutes of encumbered assets or the natural fruits or products of those assets. In the absence of new financing by the secured creditor, the case for recognizing the creditor's right in these new assets is less compelling.

b. Limitations on the enforcement of security rights

16. Many insolvency laws limit the rights of creditors to pursue any remedies or proceedings against the debtor after insolvency proceedings are commenced, through the imposition of a stay or moratorium. The stay may be imposed either automatically or in the discretion of a court, either on its own motion or on application of an interested party. A number of jurisdictions extend the stay to both unsecured and secured creditors. The same reasons for including encumbered assets within the estate (see para. 13) apply to the stay of enforcement of security rights. Limitations, however, on a secured creditor's ability to enforce its security right may have an adverse impact on the cost and availability of credit. An insolvency law must balance these competing interests (see A/CN.9/WG.V/WP.63/Add.6).

17. Some insolvency laws authorize the court to order protective measures to preserve the estate in the period between a petition to open insolvency proceedings and the court's decision on the petition. These laws typically permit the court to order these protective measures in its discretion, either on its own motion or on application of an interested party. Where these provisional measures are available they may include staying a secured creditor from taking possession of encumbered assets or otherwise enforcing its security right. Because these measures are provisional and are ordered before the decision to commence proceedings, creditors requesting these measures may be required by the court to provide evidence that the measure is necessary and, in some cases, some form of security for costs or damages that may be incurred.

18. With few exceptions (see para. 11), the need to stay enforcement of a security right for a substantial period of time is less compelling when the insolvency proceeding is a liquidation proceeding. In most liquidation proceedings, the insolvency representative will dispose of assets individually rather than by selling the business as a going concern. Different approaches may be taken to account for this. For example, an insolvency regime may exclude secured creditors from the application of the stay, but encourage negotiations between the insolvent debtor and the creditors prior to commencement of the insolvency proceedings to achieve the best outcome for all parties. An alternative approach would provide that in insolvency proceedings the stay lapses after a brief prescribed period of time (e.g. 30 days) unless a court order is obtained, extending the stay on grounds specified in the insolvency law. These grounds might include a demonstration that there is a reasonable possibility the business will be sold as a going concern; this sale will maximize the value of the business; and secured creditors will not suffer unreasonable harm. Yet another approach is to leave the lifting of the stay to the discretion of the court supervising the insolvency proceedings but to provide statutory guidelines for the exercise of this discretion (see A/CN.9/WG.V/WP.63/Add.6, paras. 80-83 and 91-92).

19. A stronger case for a stay is made when the insolvency proceeding is a reorganization proceeding. The objective of such a proceeding is to restructure a potentially economically viable entity so as to restore the financial well being and viability of the business, to maximize the return to creditors, and to maintain employment. This may involve restructuring the finances of the business by such means as debt rescheduling, debt reduction, debt-equity conversions, and sale of all or part of the business as a going concern. Removal of encumbered assets from the business will often defeat attempts to continue the business or to sell it as a going concern. Accordingly, an insolvency law might extend the application of a stay to secured creditors for the time period necessary to formulate, present to creditors and implement a reorganization plan to creditors (see A/CN.9/WG.V/WP.63/Add.6, para. 91).

20. If an enforcement action by a secured creditor is stayed, an insolvency regime should provide safeguards to protect the economic value of the security rights in the encumbered assets. Such safeguards might include court orders for cash payments for interest on the secured claim, payments to compensate for the depreciation of the encumbered assets, and extension of the security right to cover additional or substitute assets. The need for such safeguards is particularly compelling when the encumbered assets are perishable or consumable (such as cash or cash equivalents).

21. In addition, an insolvency law might also relieve a secured creditor from the burden of a stay by authorizing the insolvency representative to release the encumbered assets to the secured creditor. Grounds for such a release might include

cases where the encumbered assets are of no value to the estate and are not essential for the sale or rehabilitation of the business, cases where it is not feasible or is overly burdensome to protect the value of the security right, and cases where the insolvency representative has failed in a timely fashion to sell or abandon the encumbered assets. An insolvency law might also provide that once the stay has been terminated with respect to particular encumbered assets, the secured creditor could use, at its cost and if it wished, procedures in the insolvency proceeding to sell the encumbered assets.

22. Where the value of the encumbered assets is greater than the secured claim, the insolvency estate has an interest in the surplus if the assets are to be liquidated. In the absence of insolvency, the secured creditor would have to account to the grantor for the surplus proceeds. If the same assets are disposed of during insolvency proceedings, the surplus would be available for distribution to other creditors. As to who should dispose of the encumbered assets, an insolvency law should address the question whether the same policies that apply outside of insolvency should apply also in insolvency proceedings. For example, if the applicable security rights law authorizes the secured creditor to dispose of an asset outside insolvency, the question is whether the secured creditor, rather than the insolvency representative, should control disposition of the relevant encumbered assets during insolvency. An insolvency law might provide that, in a liquidation procedure, the encumbered assets would be turned over to the secured creditor if there was a reasonable indication that the secured creditor would sell them more easily and at a better price. In any event, the insolvency law should make clear that any surplus after paying reasonable expenses and satisfying the secured claim should be returned to the insolvency estate.

c. Participation of secured creditors in insolvency proceedings

23. If secured creditors are required to participate in insolvency proceedings, the insolvency regime should ensure that participation is effective to protect the interests of secured creditors (see A/CN.9/WG.V/WP.63/Add.11). For example, the notification to creditors announcing the commencement of insolvency proceedings should indicate whether secured creditors need to make a claim and, if so, to what extent.¹ Secured creditors should have at least the same standing in court proceedings as other creditors.

24. In addition, if an insolvency law provides for creditor committees to advise the insolvency representative, the law should provide for adequate representation of the interests of secured creditors. Secured creditor representatives may sit on a committee with representatives of unsecured creditors or, alternatively, the law might provide for a separate committee for secured creditors. Concerns that in the context of a single committee the interests of secured creditors might dominate proceedings to the detriment of other creditors, might be addressed by limiting the issues on which secured creditors may vote. For example, voting might be restricted to the selection of the insolvency representative and matters directly affecting encumbered assets or the economic value of security rights.

¹ For notification to foreign creditors, see article 14 of the UNCITRAL Model Law on Cross-Border Insolvency and paras. 106-111 of the Guide to Enactment of the Model Law.

d. The validity of security rights and avoidance actions

25. In general, a security right valid against third parties outside of insolvency should be recognized as valid in an insolvency proceeding. However, a challenge to the validity of a security right in insolvency proceedings should be allowed on the same grounds that any other claim might be challenged. Many jurisdictions allow an insolvency representative, for example, to set aside (“avoid”) or otherwise render ineffective any fraudulent or preferential transfer made by the insolvency debtor within a certain period before the commencement of insolvency proceedings. The creation or transfer of a security right is a transfer of property subject to these general provisions, and if that transfer is fraudulent or preferential, the insolvency representative should be entitled to avoid or otherwise render ineffective the security right. This would mean that a security right, which is valid under the secured transaction regime of a jurisdiction, may be invalidated, in certain circumstances, under the insolvency regime of the same jurisdiction (see A/CN.9/WG.V/WP.63/Add.9). In any event, the insolvency law should set out any grounds for avoidance of a security right in clear and predictable terms. Payment of proceeds after the commencement of insolvency proceedings (see para. 15), should be possible, unless such payment is fraudulent or voidable under other applicable principles.

e. The relative priority of security rights

26. A secured transaction regime will establish the priority of claims to encumbered assets. In exceptional situations, insolvency laws may affect that priority (see A/CN.9/WG.V/WP.63/Add. 14). Many laws, for example, give a priority to one or more of the following classes of claims: unpaid wages and employee benefits, environmental damage and Government taxes (“privileged claims”). While most legal systems award these claims priority only over unsecured claims, some regimes extend the priority to rank ahead of even secured claims.

[Note to the Working Groups: The Working Groups may wish to consider adding a new paragraph along the following lines: “Some laws alter the pre-insolvency ranking of secured and unsecured creditors by setting aside a portion of the estate, including encumbered assets, for the benefit of some classes of unsecured creditors, such as employees of the debtor or persons with personal injury claims against the debtor. Some other laws, to discourage egregious conduct by secured creditors before insolvency proceedings commence, provide that in exceptional circumstances the priority of a secured creditor’s security right may be reduced. Examples might include situations in which the secured creditor dictates major decisions by the company prior to the commencement of insolvency proceedings or the secured creditor engages in inequitable conduct prior to the insolvency proceedings relative to the company or its creditors.”]

27. The greater the uncertainty regarding the number and amounts of claims given priority over claims of secured creditors, the greater will be the negative impact on the availability and cost of credit. It is, therefore, essential that exceptions to the priority of secured creditors be limited, in number and monetary amount, and that the existence and amount of these exceptions be expressed in a transparent and predictable way. For example, the exceptions should be set forth, not only in labour or tax law, but also in insolvency and secured transactions law.

28. The insolvency representative may incur costs in the maintenance of encumbered assets and pay for these costs from the general funds of the insolvency

estate. Because such expenditure preserves the economic value of the security right, not to grant priority over the secured creditor for these administrative expenses would unjustly enrich the secured creditor to the detriment of the unsecured creditors. To discourage unreasonable expenditure, however, an insolvency law might limit the priority to the reasonable cost of foreseeable expenses that directly preserve or protect the encumbered assets. As a general rule, the insolvency law should not subject the value of the encumbered assets to a surcharge for the general administration of the insolvency proceeding. An exception includes the case where the value of the encumbered assets does not meet the full value of the secured creditor's claim, there are no other assets and the secured creditor does not object to the insolvency proceeding.

f. Post-commencement financing

29. In order for an insolvency proceeding to yield the maximum return for all creditors, either through liquidation or reorganization, the insolvency representative must have sufficient funds available to it to fund the expenses of the liquidation or reorganization. In the case of a liquidation, these expenses may include the cost of preserving and protecting the debtor's assets pending their sale or other disposition. In the case of a reorganization, the expenses may include funding payroll and other operating expenses to enable the debtor to carry on its business as a going concern during the insolvency proceeding.

30. In some cases, the insolvency representative may already have sufficient liquid assets to fund such anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables). However, these assets may already be subject to valid security rights held by the debtor's pre-existing creditors (such as a lender that has security rights in the debtor's receivables arising as proceeds from the sale of inventory). The use of such assets by the insolvency representative during the insolvency proceeding could well impair, or even destroy, the economic value of such security rights. As a result, an insolvency representative should only be permitted to use such assets in the insolvency proceeding to the extent that the rights of pre-existing secured creditors to receive the economic value of their security rights are protected. Otherwise, prospective secured creditors will be reluctant to extend credit to a debtor knowing that, if the debtor were to become subject to an insolvency proceeding, they could lose the economic value of their security rights as a result of the use of those assets in the insolvency proceeding.

31. In other cases, the insolvency estate's existing liquid assets and anticipated cash flow may be insufficient to fund the expenses of the insolvency proceeding, and the insolvency representative must seek financing from third parties. Such financing may take the form of credit extended to the debtor by vendors of goods and services, or loans or other forms of credit extended by lenders. Often, these are the same vendors and lenders that extended credit to the debtor prior to the insolvency proceeding. Typically, these providers of credit will only be willing to extend credit to an insolvency estate if they receive appropriate assurance (either in the form of a priority claim on, or security rights in, the assets of the insolvent debtor) that they will be repaid. Yet here again, those assets may already be subject to valid security rights held by the debtor's pre-existing creditors and, for the reason described in the preceding paragraph, new creditors asked to extend credit to the insolvency estate should only be given a priority claim or security rights in the insolvent debtor's existing or future assets to the extent that the rights of any pre-existing holders of security rights to receive the economic value are protected.

32. Thus, in any of these financing arrangements (referred to collectively as “post-commencement financing”) it is essential that the economic value of the security rights of pre-existing secured creditors is protected so that the secured creditors will not be unreasonably harmed. If the existing secured creditors’ encumbered assets are of a value significantly in excess of the amount of the secured obligations owing to them, no special protections to the pre-existing secured creditors may be necessary initially (subject to the creditors’ right to ask for protection at a later date if circumstances change). However, in many cases such an excess does not exist, and the pre-existing secured creditors should receive additional protections to preserve the economic value of their security rights, such as periodic payments or security rights in additional assets in substitution for the assets be used by the insolvency representative or encumbered in favour of a new lender.

33. In providing additional protections to a pre-existing secured creditor, it is likewise important that such creditor not receive greater security rights than it would have been entitled to if there were no post-commencement financing. Thus, the granting of additional security rights should not result in the pre-existing creditor improving its pre-insolvency secured position by, for example, securing pre-insolvency obligations that were unsecured. Rather, any additional security rights granted to a pre-existing secured creditor should secure only the insolvency estate’s obligation to reimburse the secured creditor for the decline in value of the encumbered assets subject to its pre-existing security rights.

34. In some legal regimes, post-commencement financing is governed by specific provisions of the insolvency law, while in other regimes there are no such provisions, and post-commencement financing is extended merely on the basis of a negotiated agreement between the new creditor and the insolvency representative. In both cases, the financing often is extended only after the entry of an order by the insolvency tribunal after a hearing conducted with notice to all affected parties.

35. This Guide recommends that specific provision for post-commencement financing be incorporated into the insolvency law, so that the circumstances in which such financing may be provided, the rules applicable thereto, and the effect of such financing on the rights of all parties may be easily ascertained, and taken into account, by a creditor considering extending credit to a solvent debtor. before an insolvency proceeding is commenced and may be taken into account by the creditor before extending the credit (for further discussion of this topic, see A/CN.9/WG.V/WP.63/Add.14).

g. Reorganization proceedings

36. The principal objective of reorganization proceedings is to maximize the value of the insolvency debtor's business in the interest of all creditors by formulating a plan for the business's rescue as well as to protect investments and preserve employment. In order to achieve these goals, it may be necessary for a secured creditor to participate in the reorganization, especially if the encumbered assets must be used in the insolvency debtor’s business for the business to be able to reorganize and for the insolvency debtor, on emergence from the insolvency proceedings, to conduct its affairs.

37. An important corollary of the secured creditor participating in the reorganization, however, is that the secured creditor should not be made worse off than if the secured creditor resorted to its non-insolvency enforcement rights to

dispose of the encumbered assets and applied the proceeds of the disposition to the secured obligations. Indeed, as a general matter, the economic value of the secured creditor's security rights should be preserved and maintained in the reorganization. Otherwise, the uncertainty created by the inability of the secured creditor to rely upon receipt of the economic value of its security rights in the event of the reorganization of the insolvency debtor in an insolvency proceeding could result in the secured creditor not extending credit to the debtor in the first place or extending the credit at a higher cost. Moreover, such preservation of value is also essential to attract the financing that the insolvency debtor will require in order to implement its reorganization plan and to operate as a rehabilitated enterprise.

38. To be sure, if the secured creditor is to participate in the reorganization, the reorganization plan might contain provisions by which its security rights are proposed to be adversely affected. Even so, the secured creditor may be willing to have its security rights be adversely affected and therefore may agree to be bound by the reorganization plan. However, if the secured creditor does not agree to be bound by the reorganization plan, the question arises as to whether the secured creditor may nevertheless be required to be bound by the reorganization plan over the secured creditor's objection.

39. If under the relevant insolvency law a secured creditor may be required to be bound by the reorganization plan over the secured creditor's objection, the secured creditor should receive the basic protection that the economic value of its security rights should not be diminished under the plan without the consent of the secured creditor. The protection of the secured creditor's security rights should be clear and transparent under the insolvency law so that the secured creditor will be able to make its decision as to whether to extend credit to the grantor and, if so, on what terms, with the certainty of knowing that its security rights will be appropriately protected if the grantor were to become an insolvent debtor and if a reorganization plan were to be adopted for the grantor over the objection of the secured creditor's class or, as the case may be, of the secured creditor itself.

40. There are several examples of ways in which the economic value of the secured creditor's security rights may be preserved in the reorganization plan even though the security rights of the secured creditor are being altered by the plan. If the plan provides that the secured creditor would receive a cash payment under the plan in exchange for the secured obligations, the cash payment should not be less than what the secured creditor would have received had it resorted to its non-insolvency enforcement rights to dispose of the encumbered assets and applied the proceeds of the disposition to the secured obligations. If the plan provides for the secured creditor to release its security rights in some encumbered assets, the plan should provide for substitute assets of at least equal value to become subject to the secured creditor's security rights, unless the remaining encumbered assets have sufficient value to enable the secured creditor to be paid in full upon any disposition or liquidation of the remaining encumbered assets. If the plan subordinates the secured creditor's security rights to those of another secured creditor, the encumbered assets should have sufficient value to enable both the senior and the subordinated secured creditors to be paid in full upon any disposition or liquidation of the encumbered assets. If the plan provides for the amount of the secured obligations constituting a monetary indebtedness to be paid over time, the secured creditor should retain its security rights and the present value of the future payments of the secured obligations, after giving effect to the restructuring of the secured obligations. In addition, the interest rate on the restructured secured obligations provided under the plan, should not be less than the amount that the secured creditor

would have been received had it resorted to its non-insolvency enforcement rights to dispose of the encumbered assets and applied the proceeds of the disposition to the secured obligations.

41. Whether the economic value of the secured creditor's security rights is preserved in a reorganization plan may be more of a factual issue rather than a legal issue in many circumstances. In the event of a contest in the insolvency proceeding as to whether the economic value of the security rights is being preserved under the plan, the determination of value will often require consideration of markets and market conditions. The valuation may, indeed, require expert testimony, especially if the treatment of the secured creditor under the plan involves encumbered assets or securities whose present value may be dependent upon the grantor's future performance and therefore may contain elements of performance risk to be factored into the determination of value. Absent agreement among the contesting parties, the insolvency tribunal will have to decide on the evidence presented whether the economic value of the security rights is being preserved.

h. Expedited reorganization proceedings

42. In recent years, significant attention has been given to the development of expedited reorganization proceedings ("expedited proceedings") as a means of streamlining the reorganization of a debtor, without the cost or delay inherent in formal reorganization proceedings, in situations where all or substantially all of the debtor's major creditors (usually other than trade creditors) are able to reach an agreement as to the terms of the reorganization.

43. Expedited proceedings may take the form of a procedure in which (i) the creditors first conduct negotiations concerning the terms of a proposed reorganization plan prior to the commencement of a formal insolvency proceeding, (ii) a formal insolvency proceeding is then commenced, and (iii) the reorganization plan is presented to the insolvency tribunal for its approval on an expedited basis (but subject to the same requirements for disclosure to, and voting by, all of the debtor's creditors and other procedural requirements that are applicable in formal reorganization proceedings). When approved, the reorganization plan would bind dissenting creditors in the same manner as in a formal reorganization proceeding. (see A/CN.9/WG.V/WP.63/Add.12). However, some proposals for expedited proceedings contemplate less involvement by the insolvency tribunal, and rely primarily on agreements by the major creditors of the debtor, with resort to the tribunal only for limited purposes. Expedited proceedings might also incorporate provisions for obtaining post-commencement financing of the debtor, and an expedited procedure for obtaining judicial review of rulings of the insolvency tribunal.

44. From the perspective of promoting the availability of low-cost secured credit, it is essential that expedited proceedings not frustrate the reasonable expectations of secured creditors, or create a circumstance in which a secured creditor is worse off in such proceedings than it would be in a formal insolvency proceeding. Thus, for example, an expedited proceeding should not, without the secured creditor's consent, deprive that creditor of its ability to realize the full economic value of its encumbered assets, and should reasonably compensate the secured creditor for any diminution in that value resulting from the use of such assets by the debtor during the proceeding. Moreover, the expedited proceeding should not frustrate the reasonable expectations of the secured creditor under its credit documents and applicable law with respect to choice of law or applicable forum.

45. As a general matter, the existence, in a given jurisdiction, of properly constructed expedited proceedings that adhere to the principles discussed above would encourage creditors to extend secured credit in that jurisdiction.

B. Summary and recommendations

46. A secured transactions regime should recognize the right of secured creditors to the economic value of their security rights and maintain the pre-insolvency priority of security rights. Any exceptions should be limited, clear and predictable.

47. In principle, encumbered assets should be included in the insolvency estate.

[Note to the Working Groups: The Working Groups may wish to consider adding a recommendation as to the question whether assets that are subject to a retention or transfer of title arrangement should be part of the insolvency estate (see para. 12 and note)].

48. If secured creditors are required to participate in insolvency proceedings, the insolvency regime should ensure that participation is sufficiently effective to protect the interests of secured creditors.

49. The distinction between insolvency proceedings designed to liquidate the assets of an insolvency debtor and proceedings designed to rescue the business of the insolvency debtor support different treatment of stays of enforcement of security rights in those proceedings. With few exceptions (see para. 11), the need to stay enforcement of a security right is less compelling when the insolvency proceeding is a liquidation proceeding than when it is a reorganization proceeding. Application of the stay, its duration, and the grounds for relief from the stay should be adjusted accordingly. In any event, the secured creditors should be provided with safeguards to ensure adequate protection of the economic value of their security rights when their right to enforce their security rights in the encumbered assets is deferred for a substantial period of time by the stay.

50. Subject to any avoidance actions, security rights created before the commencement of an insolvency proceeding should be equally valid in an insolvency proceeding.

51. As a general rule, insolvency proceedings should not alter the priority of secured claims prevailing before the commencement of the insolvency proceedings. Certainty and transparency with respect to any necessary exceptions will help limit the negative impact on the availability and cost of credit.

52. An insolvency law should incorporate specific provision for post-commencement financing so that a creditor extending credit to a debtor before an insolvency proceeding is commenced may take into account the possibility of post-commencement financing before extending the credit (see A/CN.9/WG.V/WP.63/Add.14).

53. Expedited proceedings should not frustrate the reasonable expectations of secured creditors, or create a circumstance in which a secured creditor is worse off in such proceedings than it would be in a formal insolvency proceeding.

General AssemblyDistr.: Limited
12 March 2002

Original: English

**United Nations Commission
on International Trade Law**Working Group VI (Security Interests)
First session
New York, 20-24 May 2002**Security Interests****Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-53	2
VI. Filing system	1-53	2
A. General remarks	1-48	2
1. Introduction	1-4	2
2. Key design issues	5-33	3
a. Notice filing	5-14	3
b. Authority to file and signature	15-17	5
c. Grantor- or asset-based index	18-21	5
d. The filing process	22-27	6
e. Duration of effectiveness of a filed notice	28-33	7
3. Other basic elements	34-48	9
a. Public access to database	34-35	9
b. Extent of detail in statutory text	36	9
c. Fees	37-41	9
d. Public or private operator	42	10
e. Effect of registry error and allocation of risk of loss	43-44	10
f. Proof of content of database	45	11
g. Alternative systems	46	11

h. Special issues in a federal State	47	11
i. Non-discrimination	48	11
B. Summary and recommendations	49-53	11

VI. Filing system

A. General remarks

1. Introduction

1. As noted in Chapter V (see, for example, A/CN.9/WG.VI/WP.2/Add.5, paras. 6-7 and 23), security rights regimes in many countries provide for publicity of a security to be made by filing notice of the security in a public registry or filing system. The term, “filing system”, is preferred here to “registry”, to emphasize that, as opposed to an immovables registry, a filing system for most forms of movable property records notice of a security only. The filing system is a non-exclusive source of limited data and it is not the source of substantive property rights. It does not record information regarding the validity and nature of the grantor’s title; and it does not evidence whether the security right exists or even whether the described asset actually exists.

2. The filing system is the forum where an announcement or advertisement is made, alerting searchers to the possibility that a security right may exist (or be acquired in the future) in certain encumbered assets that the grantor has (or may acquire in the future) an interest in. As such, the filing system has to be understood to exist in the context of alternate sources of information (e.g. the grantor itself or credit information providers). The data that constitutes that announcement is referred to as a “notice”.

3. While the design and detail of the filing system will be determined by the substantive law of the particular security rights regime and may vary, its functions include:

- (i) to provide a tool for assisting with priority determinations (see Chapter VII). An effective filing system allows prospective competing interests to determine quickly and easily what their priority would be;
- (ii) to alert interested third parties to the possible existence, present or future, of a conflicting security right;
- (iii) to decrease the risk of fraud; and
- (iv) to serve as a precondition for enforceability of the security right against the grantor (see Chapter IX).

4. A system of filing a notice (i.e. limited data) rather than a copy of the financing transaction presents several advantages. It is fast, efficient and flexible. It minimizes the need for filing office resources, while maximizing privacy of financial details (see paras. 5-17; see also A/CN.9/WG.VI/WP.2/Add.5, paras. 22-23).

2. Key design issues

a. Notice filing v. document filing

5. Assuming a notice filing system, as discussed above, is implemented, a security rights regime should state clearly that the term “notice” does not refer to a form or a document but to an aggregate of information. It should also state that notice may refer to one or more grantors and to one or more secured creditors, and that the effect of a notice is not limited to a single transaction.

6. Regarding the information to be included in a notice, the regime might require only the minimum data necessary to warn searchers of the possibility of another claim. Searchers, if they wish, can then obtain any further information required from other sources. Obstacles to access and excessive formalities should be avoided.

7. The data required for a notice to be legally sufficient might be limited to three elements: identification of the debtor (or grantor, in the case of a third-party grantor); identification of a name of a secured creditor; and description of assets in the notice. These elements are discussed below in further detail.

(i) Identification of the grantor

8. Identification of the grantor is most important, since the key to discovery of the notice by a searcher is the grantor’s name (see para. 19). Many jurisdictions have an entity registration system providing a public record with the precise entity name and, quite often, the assignment of an identification number to the entity. Many jurisdictions also assign some identification number to each individual or use a birth date as an aid to identification. As an additional identification item, the identification number would assist searchers in determining whether a particular notice refers to the person with respect to whom the search is being made. This additional item need not be an element of legal sufficiency of the notice. This element might also include the grantor’s address as a desired additional item, but again, this need not affect legal sufficiency. Additional issues may arise from the search logic that the system employs. For example, names of individuals are usually indexed in alphabetical order based on family name, while names of entities are indexed alphabetically exactly as presented. Filing rules will be needed to require the party presenting the notice to identify whether the grantor is an individual or an entity and, in the former case, which is the family name.

(ii) Identification of the secured creditor

9. The key to finding a notice should be the grantor’s name, not that of the secured creditor. Identification of the secured creditor provides a method for establishing that a party that claims a benefit based upon the notice is indeed the party entitled to do so (the filing of the notice is for this party’s future benefit). This element need not be the name of the intended secured creditor itself, but may be an agent (whose agency status need not be disclosed; this approach is of particular value in syndicated loans). While this information is not as important as identifying the grantor, if the notice provides misleading information regarding the identification of the secured creditor, the secured creditor may suffer the

consequences vis-à-vis the misled party, but this should have no effect on the legal sufficiency of the filing. An address for the secured creditor may also be desirable, though not as an element of legal sufficiency. If an address is required, the secured creditor should bear both the risk of loss actually caused to any third party by an incorrect address and the risk of non-receipt of any statutory communication to be sent to the secured creditor at the address provided in the notice (e.g. a notification of a purchase money security right).

(iii) Description of assets covered in the notice

10. The description of the encumbered assets in the notice need not be congruent with the description in the security agreement for the notice to be legally sufficient. Coverage by the notice does not expand the property rights created under the security agreement; it is the security agreement, not the notice, which creates the secured creditor's property rights and determines the scope of the encumbered assets. The grantor should be enabled to police against, and have adequate remedies for, any unauthorized excess of encumbered assets coverage in the notice. The stringency of this requirement should go only to whether a searcher would reasonably have been put on notice of the possible coverage of a potential conflicting claim. As long as the grantor is adequately protected, regulation of the description in the notice of encumbered assets should be relaxed, so as not to create unnecessary inefficiencies and risk of error. Therefore, the description need not be specific and may be by type or category of asset. This is particularly useful in the context of coverage of future assets. Moreover, detailed descriptions may be confusing and lead to error.

(iv) Maximum amount

11. Another element that is sometimes suggested is a requirement that the notice specify a maximum amount of secured credit that gains the benefit derived (in terms of priority) from the filing of the notice. Since this is frequently discussed in the context of the content of the notice, it is also examined here.

12. The advantage of setting a maximum amount in the notice is that additional credit can thereby be obtained, as other credit providers can secure other obligations with any value in excess of the stated maximum, without needing an inter-creditor agreement with the existing secured creditor (who otherwise would have priority ("would be senior"), having filed earlier). The disadvantage though of capping the priority attributable to a filed notice is that it complicates and increases the cost of obtaining additional credit from the existing secured creditor, who will often be the most likely and least costly source of additional credit (for a more detailed discussion of this matter, see A/CN.9/WG.VI/WP.2/Add.5, paras. 35-37 and Add.7, paras. 46-48).

(v) Pre-filing

13. A security rights regime should provide that a notice may be filed prior to the making of a security agreement, i.e. no obligation need exist at the time of filing. The advantages and disadvantages of "pre-filing" have been explained in Chapter V (see A/CN.9/WG.VI/WP.2/Add.5, paras. 24-28). The benefits of permitting pre-filing may well outweigh any concerns about protecting the grantor, in the event a filing made prior to the creation of the security right is rendered inappropriate

because the transaction has not gone forward. The grantor could possibly be protected by provisions requiring the secured creditor to provide a termination upon appropriate demand, similar to the provisions applicable when the secured obligation has been satisfied by payment.

(vi) Domestic and foreign grantors

14. A single filing system, covering both domestic and foreign grantors, as well as all types of grantors (i.e. every form of legal person as well as individuals), would maximize the efficiency of the security regime.

b. Authority to file and signature

15. A filed notice that has not been authorized by the grantor (or, in the case of a termination or continuation, by the secured creditor) should have no legal effect. However, a signature should not be a standard requirement for the notice to be effective.

16. Imposing a requirement of a signature would increase the obligations of the parties to the transaction, as well as administrative costs. Even if electronic signatures were provided for (so that the signature requirement did not of itself preclude electronic filing), a signature requirement might well make the process more expensive and cumbersome, particularly if the electronic signature provisions of a jurisdiction dictate a specific technology. In fact, a traditional signature requirement did not preclude forgery. Moreover, filing office personnel may be ill-suited to detect forgery, and the effort to detect forgery would be a diversion of scarce resources and would slow down the intake process for all filings.

17. In the rare case of a mischievous filing, an aggrieved grantor should be able to seek judicial relief. Further measures aimed at protecting the grantor may be provided, at a greater cost to the secured credit regime. One approach, for example, could be to give the grantor the right to initiate a process to expunge the unauthorized notice. In such a case, the filing office should be obliged to send a notification to the secured creditor identified in the notice. If the secured creditor did not respond within a stated period of time, the regime could provide for a judicial decision or an automatic deletion of the notice from the record. The deterrent effect of such a statutory penalty is likely to effectively limit secured creditor misconduct. In any case, in determining whether there should be greater protection for the grantor, legislators may need to weigh the magnitude of the risk of filer error, intentional or not, against the cost and risk of loss that might be suffered by secured parties due to grantor error (e.g. a grantor wrongfully filing a termination or wrongfully seeking deletion).

c. Grantor- or asset-based index

18. Traditional registries familiar to many countries, such as those for aircraft or patents, are fundamentally ownership registries that may also encompass transfers of rights that are less than full ownership (these registries are asset-based). Such transfers involve high value serial-numbered non-fungible assets, in contrast to much of the property that will be covered by the movables security regime, where individual description, even of tangibles, is difficult if not impossible, particularly

so if the regime covers future property. Use of asset description or serial numbers as the basis for the index in a general movables security filing system is impossible.

19. This leaves grantor identification as the basis for the index. This may be based on the grantor name, or, in some countries, grantor identification number (see para. 8), or even a combination of the two. This puts great importance on the grantor name being correct, which is a problem particularly in systems where the bulk of the filings can reasonably be expected to be against grantors who are individuals. This will depend on whether business is carried out in the sole proprietorship rather than in the entity form, and on whether the filing system covers passenger motor vehicles. The significance of the difficulty in providing the grantor's name with perfect accuracy will vary from country to country, depending on the existence of a mandatory identification or internal identification regime that could be the basis for a single reliable and verifiable name for each individual. In some countries, non-private identification numbers are issued to individuals; these might be used in addition to or in lieu of names. With respect to names of grantors that are legal persons, there is frequently a public registry of those entities that makes possible a single reliable and verifiable name.

20. Devising a filing system usable across borders would present issues relating to multi-lingual databases. Dealing with a multi-alphabet database may present more difficult problems, although within a particular jurisdiction, the issue of a multi-alphabet database is less likely to arise. These problems may be alleviated by the use of grantor identification by number or other element in view of recent technological advances.

21. With respect to certain types of high-value assets that can be individually identifiable, such as motor vehicles, there is typically an identification number issued by a government agency or other recognized and reliable source. In such cases, the grantor-based index can, with respect to those types of asset, be supplemented by an asset-based index, with identification of the encumbered assets by number being made a condition to priority over specified competing interests, particularly buyers.

d. The filing process

22. An issue that must be addressed at the outset is whether the filing system should be based on electronic filing, either exclusively or optionally, and whether it should accommodate input via paper filings.

23. There can be no dispute about the superior efficiency and speed of electronic filing. It appropriately shifts all responsibility for accurate data input from the filing office onto the filer. An electronic system can, upon filing, instantaneously process, index and confirm the fact of filing. It can also be programmed to reduce inputting errors on the part of the filer. This technology already exists and is in operation in several jurisdictions. There are significant cost savings in the operation and maintenance of an electronic system, once set-up costs have been met. With a view to encouraging the extension of credit by foreign credit institutions, an electronic system might facilitate even multinational searching.

24. While the utilization of computers in less developed countries may be limited, it is likely that higher volume filers (e.g. financial institutions) will have

access to computers. Given that, it is unlikely that any new system implemented in the future would involve paper input only. The additional operating costs and the added legislative complexity when both electronic and paper filing co-exist (e.g. dealing with time lags between presentation and availability for search, an issue that exists only with respect to paper filings) militate in favour of preferring exclusively electronic filing, though this is dependent upon the infrastructure in the jurisdiction.

25. Issues such as the location of physical facilities are also alleviated by electronic filing. Only one repository (whether filings are on paper or electronic) is necessary which should require few employees. A regime that provides multiple intake sites may encounter “proper place to file” issues (both *ab initio* and upon change of the determining factor) or, possibly, issues of simultaneous filings against the same debtor in different offices.

26. A regime might make clear the limited role of the system operator by specifying the only permissible grounds for rejection of filings. This issue is also mitigated by electronic filing, which eliminates human intervention in the intake process. Archiving, searching and reporting are non-discretionary tasks. Administrative staff should be fully cognisant of the differences between the filing system and traditional registries and all of their conduct should reflect those differences. The regime should also provide for the maintenance and destruction of records.

27. All design decisions should be tested against the general principle that the filing system, as a key element of an effective and efficient movables security regime, should be simple, transparent and user-friendly both for filers and searchers. Even in a purely paper-input system, the database can and should be computerized. Computerization provides more efficient record-keeping and searching and should prove less costly to operate. It also enhances the integrity of the system by diminishing the possibility of human error and misconduct.

e. Duration of effectiveness of a filed notice

28. Three options exist for the period of effectiveness of a filed notice. The period may be:

- (i) of unlimited duration, ended only by the authorized filing of a termination;
- (ii) or a fixed term (including infinity) selected by the filer initially, subject to extension by the filing of a continuation; or
- (iii) a common statutory fixed term, subject to extension by the filing of a continuation.

29. Most personal property secured financing extends over a relatively short period, in many jurisdictions rarely more than five to seven years. It is, however, often difficult to foretell precisely how long the effectiveness of the filing may be needed, as some transactions are open-ended and others of a fixed term initially are often, by agreement or by reason of the debtor’s default, extended beyond the due date initially provided for the credit. Consequently, when filers are empowered to select a term, they usually select a term longer than that fixed in the credit documents (higher fees are not a deterrent since debtors have to pay the filing fees as a cost of the credit extension).

30. Options (i) and (iii) have an administrative advantage, in that all filings are good forever or are good for a uniform fixed term, which avoids complications from individualization of the intake process (i.e. from having to deal with individual duration selections and, therefore, with fee variations and the consequent potential for rejections if the correct fee is not paid). Option (iii) has the further advantage of making the archive “self-cleansing” (i.e. filings expire after a period of time). This is important not only in the paper context but also for electronic systems. While electronic archive space is less expensive than that for paper files, storage is not the only factor. There is also the factor of retention in the database and furnishing searchers with information that is no longer useful. Moreover, when a filing’s life has ended by virtue of having been permitted to reach the end of the fixed term without the filing of a continuation, issues relating to filing of terminations are avoided.

31. While it is an issue of lesser significance in option (iii), the termination of the effectiveness of a filing needs to be addressed in all three options. Terminations serve both the public purpose of clearing the archive of filings that are no longer effective (reducing the quantity of data provided in response to searches) and the private purpose of allowing the grantor to offer a clear record, showing no encumbrances (and therefore no existing priority), to a future credit provider. While the obligation of a secured creditor to provide a termination is a matter of substantive law dealt with in Chapter VIII (see A/CN.9/WG.VI/WP.2/Add.8, paras. ...), any system built on the filing of terminations must provide protection against terminations filed erroneously (by the secured creditor identified in the notice or by a stranger) or mischievously filed (by the grantor). In some existing systems, the filing office must notify the secured creditor that a termination has been filed (the termination only becomes effective if the secured creditor does not seek to prevent that termination within a stated time period). This method imposes time and monetary costs on the parties. Alleviation of these costs requires determining which party shall bear which risks and burdens.

32. Upon full satisfaction of all of the secured obligations, the grantor must be entitled to obtain a termination from the secured creditor. A statutory penalty may be imposed on the secured creditor in the event of non-compliance (e.g. fine or liability to damages). An alternative approach, as discussed above (see para. 34), might require the filing office to notify the secured creditor of receipt of a termination, which, in the absence of an objection by the secured creditor, would become effective upon the expiration of a fixed period. This approach would require some system for adjudication in the event of dispute, and allocation of risk during the period preceding final adjudication. Credit suppliers will require reasonable notice from the filing office to minimize the risk of grantor mischief.

33. The security rights regime should clearly state what occurs if a secured creditor fails to file a continuation statement within the prescribed time, and should make clear the effect of lapse on the priority previously enjoyed by the secured creditor (which might differ vis-à-vis different competing claimants). The regime should also provide for:

- (i) the method for accomplishing continuation and termination;
- (ii) judicial or administrative cancellation;
- (iii) the effect of, and method of dealing with, subsequent events such as, for example: a change in the name of the grantor; the transfer of

encumbered assets by the grantor; a change in location of the grantor or of the encumbered assets (to the extent these are relevant to the determination of the proper place for filing); or the need to amend the name under which the filing is indexed in the event of a change in the name of the grantor;

(iv) the method for dealing with other amendments (e.g. encumbered assets changes and party changes such as an assignment of the security interest by the secured creditor).

3. Other basic elements

a. Public access to the database

34. In many countries, with respect to traditional registries, it is normal practice to oblige an inquirer to establish a *bona fide* interest satisfactory to the registrar in order to search. In some countries, access is limited in the context of rules that only regulated financial entities are entitled to the benefit of certain movables security devices. However, impediments to access, such as qualification by the filing office, may cause delay or inappropriate exclusion. Many persons having or considering any sort of dealings with the grantor may have legitimate reasons for seeking access to the database. As the notice provides only minimal data, privacy concerns are less significant. It is, therefore, important that the regime explicitly state that anyone may file or search the security rights filing system, without interference by its administrator.

35. Technically, the index and the database could easily be made available, at no charge, to remote searchers (excluding the ability to modify content). With respect to filing, the degree of security desired will influence the technological architecture of the system. In all events, any proposed restriction on access should be tempered by an objective to make the system user-friendly and a recognition that the goal of the movables security regime is to enhance the availability of lower-cost credit.

b. Extent of detail in statutory text

36. Although the tasks of the filing office may be detailed, the regime need only regulate the basic intake, search facilitation and archiving responsibilities of the filing office. A balance must be struck between drafting simple and flexible regulation, and ensuring certainty and administrative transparency. The duties and obligations, discretion and performance standards of the system operator should all be clearly prescribed for by the regime.

c. Fees

37. High filing and searching fees will undermine the policy objective of security transactions law reform to expand the availability of and reduce the cost of secured credit. Filing fees should be set at a low level to enable and encourage use of the filing system in the widest range of transactions.

38. Establishing the filing system as a revenue source (beyond cost recovery) would also run counter to an objective of promoting low-cost secured credit. Filing fees for financing statements designed to raise revenue are tantamount to a tax, borne by debtors, on secured transactions. The negative effect of stamp duties,

including the consequent incentive to avoid the dutiable format, provides instructive experience.

39. While cost recovery should be the ultimate purpose of any fees charged, this notion should be viewed in light of the overall goals of the legislation. If a substantial initiation cost is incurred in setting up the filing system, this should be recovered over a long period of time in order to keep the fee as low as possible. Ultimately, it is the debtor who bears the burden of the fee.

40. Numerous methods of payment are now technologically feasible and, to ensure simplicity and flexibility, as many alternatives as possible should be offered, ranging from pre-arranged accounts (with prepaid deposits) maintained by frequent filers to capability to use credit or debit cards or a form of electronic funds transfer.

41. From a process design standpoint, the simplest structure may be to charge a fee only at the time of the initial filing (leaving subsequent filings free of any additional fees). The single fee might be determined by dividing the expected operating budget for the system by the expected number of initial filings. While this approach does shift some costs to grantors whose filing circumstances are less filing-intensive (e.g. no amendments) from those whose circumstances do involve post-initial filings, overall simplicity for system users and for the filing office (plus the advantage of an early collection of the fee) support the adoption of this approach. Many existing systems already provide this feature to some extent by not requiring a fee for filing terminations (which also encourages the filing of terminations). A searching fee is not necessary if the system provides internet or similar remote access to the database for self-searching (which requires no particular service by the filing office, although there will be some general system maintenance). A system that permits remote access for searching the index and the database, free of charge, might charge fees for certification or for copies of items in the database.

d. Public or private operator

42. Reluctance to increase government bureaucracy should not be a basis for rejecting the notion of a filing system as part of a movables security regime. As the role of the system operator is limited, the system need not be operated by a government entity. However, each jurisdiction should provide a method for supervision and control of the operator of the system, and allow users to seek review of filing office conduct or inaction (whether judicial, administrative, or a combination of the two). The review methodology should be accessible and expeditious. If an effective general review methodology already exists in the jurisdiction, the secured transactions legislation need not address this matter.

e. Effect of registry error and allocation of risk of loss

43. If the system is exclusively electronic, there will be little opportunity for filing office error. Even in a paper-based system, experience has not revealed many known losses suffered as a consequence of filing office error. The domestic legal system might already generally provide for either liability (or some sort of mandatory insurance) or immunity for filing office error.

44. In any case, it would be advisable for the security rights regime to clearly allocate risks between filers and searchers on the basis of efficiency. In most cases, this would mean protecting the filer at the expense of the subsequent searcher, although this rule can be mitigated in certain cases if it is deemed desirable to do so. For example, a rule might provide that an indexing error does not preclude effectiveness of the filing. This approach might, however, be modified to provide that it does not render the filing ineffective but only subordinates it to a subsequent filer who can establish that it searched and was misled by the indexing error. The policy judgement is a matter of allocating the risks between the earlier filer and the later filer. Thus, a rule that imposes the risk of an indexing error on the first filer would likely produce the practice of each filer performing a follow-up search. This practice, however, would burden all filings with extra cost and delay, and burden the system with many additional searches. Whether this approach is sensible depends in part on assumptions made about the likely frequency of both error and subsequent additional financing. This is also partly a matter of efficiency of the system in the sense that the decision might be affected by the availability of a remedy against the filing office. In many jurisdictions, the filing office enjoys sovereign immunity, while in others, a remedy for government error is available.

f. Proof of content of database

45. Proof of content of the database is a matter of the law of evidence. A rule on this subject may be helpful in some jurisdictions.

g. Alternative systems

46. Alternative systems include special systems for land, motor vehicles, air and sea vessels, and certain types of intellectual property. Specific filing systems for these types of assets are designed primarily to assure ownership and may not be well-suited to the needs of modern finance (for a discussion of coordination between registries, see A/CN.9/WG.VI/WP.2/Add.5, paras. 41-43).

h. Special issues in a federal State

47. While it is likely that a multi-unit State will have to confront special political problems and special choice of law issues, many of these issues can be rendered significantly less important by means of technology, particularly, if the filing systems can provide for a unified index and database (whether there is a single filing office or multiple filing offices).

i. Non-discrimination

48. The system should be accessible to both domestic and foreign creditors for both filing and searching purposes. In this way, sources of credit will be expanded to include foreign credit institutions.

B. Summary and recommendations

49. A notice filing system, as contrasted to a document filing system is more suited to a security rights regime. For efficiency and cost-saving reasons, the

information required might be limited to identification of the debtor, identification of the secured creditor and a description of the assets.

[Note to the Working Group: On the issue of a maximum amount in the notice, pre-filing and types of grantor covered, see note to the Working Group at the end of Chapter V in A/CN.9/WG.VI/WP.2/Add.5.]

50. A signature requirement for the legal sufficiency of a notice is not recommended, as this increases the obligations of the parties and administrative costs. A filed notice that has not been authorized by the grantor should have no legal effect. Other measures designed to protect the grantor may be introduced at a greater cost to the secured credit regime.

51. Much of the property that will be covered by a general security rights regime is not capable of individual description. This means it is not possible to use asset description as the basis for an index in a general security rights filing system, covering movables. The system may instead be indexed on the grantor name, an assigned grantor identification number or a combination of the two. This may be varied for those types of assets that can be individually identified.

52. A system based on electronic filing is highly recommended, for reasons of efficiency, ease of use and increased access. These advantages apply equally to filers, searchers and administrators.

53. Different approaches may be taken to the period of effectiveness of a filed notice. The period may be: of unlimited duration, ended only by the authorized filing of a termination; a fixed term (including infinity) selected by the filer initially, subject to extension by the filing of a continuation; or a statutory fixed term, subject to extension by the filing of a continuation. Certainty of the term of effectiveness is an important consideration, as is its termination. The regime should address the process for termination and provide remedies for misconduct. The regime should also provide processes for continuation and any amendments of the notice.

[Note to the Working Group: The Working Group may wish to consider whether international registries should be established as part of the regime envisaged in this Guide and, if so, discuss the issue of coordination between national and international registries. In its consideration, the Working Group may wish to take into account the international registries foreseen in various treaties such as the Convention on International Interests in Mobile Equipment and the Assignment Convention (optional Annex).]

General AssemblyDistr.: Limited
6 March 2002

Original: English



**United Nations Commission
on International Trade Law**

Working Group VI (Security Interests)
First session
New York, 20-24 May 2002

Security Interests**Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-71	2
VII. Priority	1-71	2
A. General remarks	1-63	2
1. The concept of priority and its importance	1-5	2
2. Priority rules	6-15	3
a. First-to-file priority rule	6-10	3
b. Priority based on possession or control	11-13	4
c. Alternative priority rules	14-15	5
3. Types of competing claimants	16-45	5
a. Other consensual creditors	16	5
b. Unsecured creditors	17-18	5
c. Sellers of encumbered assets	19-25	6
d. Buyers of encumbered assets	26-32	7
e. Judgement or execution creditors	33-37	9
f. Statutory (preferential creditors)	38-39	10
g. Creditors adding value or storing encumbered assets	40-42	11

h. Insolvency administrators	43-45	11
4. Priority in future advances and after-acquired property	46-50	12
a. Future advances	46-48	12
b. After-acquired property.	49-50	13
5. Priority in proceeds	51-59	13
6. Voluntary alteration of priority: subordination agreements	60-61	15
7. Relevance of priority prior to enforcement	62-63	15
B. Summary and recommendations.	64-71	15

VII. Priority

A. General remarks

1. The concept of priority and its importance

1. The term “security right,” as used in this Guide, refers to an *in rem* right (i.e. a right in property granted to a creditor to secure the payment or other performance of an obligation). The term “priority,” on the other hand, refers to the extent to which the creditor may derive the economic benefit of that right in preference to other parties claiming an interest in the same property see A/CN.9/WG.VI/WP.2/Add.1, para. 9, definition of “priority”). As discussed below, these competing claimants may include holders of consensual security rights in the property, holders of unsecured debt, sellers of the property, buyers of the property, holders of non-consensual security rights in the property (such as security rights arising from judgements or created by statute) and the insolvency administrator of the grantor.

2. The concept of priority is at the core of every successful legal regime governing security rights. While some have questioned why one creditor should ever be given priority over another creditor, it is widely recognized that a priority rule is necessary to promote the availability of low-cost secured credit. Moreover, a clear priority rule that leads to predictable outcomes allows all creditors, even unsecured creditors, to assess their positions in advance of extending credit and to take steps to protect their rights.

3. A creditor will normally extend credit on the basis of the value of specific property only if the creditor is able to determine, with a high degree of certainty at the time it extends the credit, the extent to which other claims will rank ahead of its security right in the property. The most critical issue for the creditor in this analysis is what its priority will be in the event of the grantor’s insolvency, especially where the encumbered asset is expected to be the creditor's primary or only source of repayment. If the creditor has any uncertainty with respect to its priority at the time it is evaluating whether to extend credit, the creditor will place less reliance on the encumbered asset. At a minimum, this uncertainty will increase the cost of the credit to reflect the diminished value of the encumbered asset to the creditor, and may even cause the creditor to refuse to extend the credit altogether.

4. To limit this uncertainty, it is important that secured lending laws include clear priority rules that lead to predictable outcomes. The existence of such rules,

together with efficient mechanisms for ascertaining and establishing priority at the time credit is advanced, may be more important to creditors than the particulars of the priority rules themselves. It often will be acceptable to a creditor if certain competing claimants have priority, as long as the creditor can determine, with a high degree of certainty, that it will ultimately be able to realize a sufficient portion of the value of the encumbered assets to repay its claim in the event of non-payment by the grantor. For example, a creditor may be willing to extend credit to a grantor based upon the value of the grantor's existing and future inventory, even though the inventory may be subject to the prior claims of the vendor who sold the inventory to the grantor, or the warehouseman who stored the inventory for the grantor, as long as the creditor can determine that, even after paying such claims, the inventory may be sold or otherwise disposed of for an amount sufficient to repay its secured obligation in full.

5. It is important to note that no matter what priority rule is in effect in any jurisdiction, it will only have relevance to the extent that the applicable conflict-of-laws rules provide that such priority rule governs. This issue is discussed in Chapter XI.

2. Priority rules

a. First-to-file priority rule

6. As discussed above (see paras. 2-4), in order to effectively promote the availability of low-cost credit, consideration should be given to establishing priority rules that permit creditors to determine their priority with the highest degree of certainty at the time they extend credit. As discussed in Chapter V and Chapter VI (see A/CN.9/WG.VI/WP.2/Add.5, paras. ..., and Add.6, paras. ...), the most effective way to provide for such certainty is to base priority on the use of a public filing system.

7. In many jurisdictions in which there is a reliable filing system, priority is generally determined by the order of filing, with priority being accorded to the earliest filing ("first-to-file priority rule"). In some situations, this rule applies even if all of the requirements for the creation of a security right have not been satisfied at the time of the filing, which avoids the need for a creditor to search the filing system again after all remaining requirements for creation have been satisfied. This rule provides the creditor with certainty that once it files a notice of its security right, no other filing, except for the limited exceptions discussed in section A.3 below, will have priority over its security right. This certainty allows creditors to assess their priority position with a high degree of confidence, and as a result, reduces their credit risk. Other creditors are also protected because the filing will put them on notice of the security right, or potential security right, and they can then take steps to protect themselves. The first-to-file priority rule does not apply in some cases (e.g. to purchase money security rights, discussed in section A.3.c. below, or to statutory creditors, discussed in section A.3.f. below).

8. This first to file priority rule is illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.2/Add.2, paras. 10 and 13). In these examples, Lender B and Lender C each have a security right in all of Agrico's existing and after-acquired

inventory and receivables. Under a first-to-file priority rule, the lender that filed a notice of its security right in the inventory and receivables first would have priority over the other lender's security right, regardless of the time that each lender's security right was obtained.

9. Some jurisdictions provide that, as long as filing occurs within a certain "grace period" after the date on which the security right is created, priority will be based on the date of creation rather than on the date of filing. Thus, a security right that is created first, but filed second, may still have priority over a security right that is created second but filed first, as long as the first security right is filed within the applicable grace period. As a result, until the grace period expires, the filing date is not a reliable measure of a creditor's priority ranking, thus resulting in significant uncertainty. In legal systems in which no such grace periods exist, creditors are not at a disadvantage because they can always protect themselves by making a timely filing.

10. In principle, the ordering of priority according to the timing of filing should apply even if the creditor acquired its security right with actual knowledge of an existing unfiled security right. Qualifications based on actual knowledge require a fact-specific investigation and would subject filings to challenge, creating a new issue for litigation and an incentive to attack filings. All this would diminish certainty as to priority status and thereby reduce the efficiency and effectiveness of the system. As in the case of grace periods, there is no unfairness to secured creditors in this approach because they can always protect themselves by making a timely filing.

b. Priority based on possession or control

11. As discussed in Chapter IV and Chapter V (see A/CN.9/WG.VI/WP.2/Add.3, paras. 5-14, and Add.4, paras. 2 and 52-54), possessory security rights traditionally have been an important component of the secured lending laws of most jurisdictions, and should be considered in crafting a priority rule. In recognition of this, in certain systems that have a first-to-file priority rule, priority alternatively may be established based on the date that the creditor obtained its security right by possession or control, without any requirement of a filing. In these systems, priority is generally afforded to the creditor that first either filed notice of its non-possessory security right in the filing system or obtained a security right by possession or control.

12. If priority may be established by date of possession or control, or alternatively by the date of filing, consideration should be given to whether a security right obtained by possession or control should ever have priority over a previously filed non-possessory security right. In the case of certain types of encumbered assets, creditors often require possession or control to prevent prohibited dispositions by the grantor. For example, creditors often require possession or control of instruments such as certificated investment securities or documents of title such as warehouse receipts and negotiable documents. For these types of assets, it may be most efficient for a security right established by possession or control always to have priority over a non-possessory security right, regardless of the date of the filing of the non-possessory security right. For other

types of assets, consideration should be given to according priority to the first creditor to file a notice of its security right or obtain possession or control of the encumbered asset.

13. The availability of alternative modes of establishing priority (i.e. control, possession and filing) raises the question of whether a secured creditor who initially established priority by one method should be permitted to change to another method, without losing its original priority ranking with respect to the encumbered asset. In principle, there is nothing objectionable about this, provided there is no gap in the continuity of control, possession or filing (i.e. at all times the security right is subject to one method or another).

c. Alternative priority rules

14. In some systems, priority is based on the date that the security right is created as opposed to the date of filing (a different first in time rule). This approach has been adopted in some jurisdictions that permit non-possessory security rights but have not adopted a reliable, or any, filing system. In these jurisdictions, a creditor is not able to confirm independently whether there are any competing security rights and must rely solely upon representations of the grantor as to the absence of such rights. This serves as a major impediment to the availability of low-cost secured credit.

15. In other systems, with respect to certain types of assets such as receivables, priority is based on the time that specified third parties are notified of the security right. Like the system described in the preceding paragraph, this system also is not conducive to the promotion of low-cost secured credit because it does not permit the creditor to determine, with a sufficient degree of certainty at the time it extends credit, whether there are any competing security rights.

3. Types of competing claimants

a. Other consensual secured creditors

16. As discussed above (see paras. 2-4), many legal systems allow the grantor to grant more than one security right in the same asset, basing the relative priority of such security rights on the priority rule (first to file or other) in effect under such system or on the agreement of the creditors. Allowing multiple security rights in the same asset in this manner enables a grantor to use the value inherent in a single asset to obtain credit from multiple sources, thereby unlocking the maximum borrowing potential of the asset.

b. Unsecured creditors

17. The grantor will often incur debts that are not secured by security rights. These general unsecured claims often comprise the bulk of the grantor's outstanding obligations.

18. While some question the fairness of giving secured creditors priority over unsecured creditors, it is well established that giving secured creditors priority over

unsecured creditors is necessary to promote the availability of secured credit. Unsecured creditors can take steps to protect their interests, such as monitoring the status of the credit, requiring security in certain instances or reducing their claims to judgements (as discussed in section A.3.e. below) in the event of non-payment. In addition, obtaining secured credit increases the capital of the grantor, which in many instances benefits the unsecured creditors by increasing the likelihood that the unsecured debt will be repaid. Thus, an essential element of an effective secured credit regime is that secured claims, properly obtained, have priority over general unsecured claims.

c. Sellers of encumbered assets

i. Purchase money security rights

19. Typically, the grantor acquires its assets by purchasing them. If the purchase is made on credit provided by the seller or is financed by a lender (“purchase money financing”; see A/CN.9.WG.VI/WP.2/Add.2, paras. 2-4, and Add.3, paras. 31-32) and the seller or lender obtains a security right in the goods acquired to secure the purchase money financing, consideration must be given to the priority of such rights *vis á vis* security rights in the same goods held by other parties.

20. Recognizing that purchase money financing is an effective means of providing businesses with capital necessary to acquire specific goods, many legal systems provide that holders of purchase money security rights have priority over other creditors (including creditors that have an earlier in time filed security right in the goods) with respect to goods acquired with the proceeds of the purchase money financing. This is a significant exception to the first-to-file priority rule discussed in section A.2.a. above.

21. This heightened priority is important in promoting the availability of purchase money financing. As illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.2/Add.2, paras. 10 and 13), businesses often grant security rights in all or some of their existing and after-acquired inventory and equipment to obtain financing. In these situations, if purchase money security rights are not afforded a heightened priority, purchase money financiers would not be able to place significant reliance on their security rights because they would rank behind existing security rights. In example 1 (see A/CN.9/WG.VI/WP.2/Add.2, paras. 4-7), Vendor A, Lender A and Lessor A would each be reluctant to provide purchase money financing if their security rights in the goods financed ranked behind the existing security rights of Lender B in example 2 and Lender C in example 3.

22. Providing heightened priority for purchase money security rights is generally not considered to be detrimental to the grantor’s other creditors, because purchase money financing does not diminish the estate (i.e. the net assets or net worth) of the grantor, but instead provides the estate with additional assets in return for the purchase money obligations. For example, the security positions of Lenders B and C in examples 2 and 3 are not diminished by a purchase money financing, because the Lenders still have all of their encumbered assets plus a security right ranking behind the additional goods financed by the purchase money credit transaction (“junior security right”). In order to promote the availability of both purchase

money financing and general secured credit, it is important that the heightened priority afforded to purchase money security rights only apply to the goods acquired with such purchase money and not to any other assets of the grantor.

23. To avoid other creditors mistakenly relying on assets subject to purchase money security rights, it is important that purchase money security rights be subject to the filing system (see A/CN.9/WG.VI/WP.2/Add.5, paras. ...). From the perspective of a competing creditor, it would be beneficial if a notice of such security rights was required to be filed at the time the rights were obtained. This would mean that any creditor could search the filing system and determine with certainty whether any of the grantor's existing assets are subject to purchase money security rights.

24. However, in order to facilitate on-the-spot financing in the sales and leasing sectors, a grace period for the filing should be considered. This grace period should be long enough so that the filing requirement is not an undue burden to purchase money financiers, but short enough so that other secured creditors are not subject to long periods before they are able to determine if any competing security rights exist. In addition, it may be wise to require purchase money financiers of inventory to give notice of their purchase money security rights to the grantor's other creditors that have security rights in inventory. The reason for such an approach lies in the fact that creditors who provide credit on a continual basis based on the value of a grantor's existing and future inventory are unlikely to search the filing system each time they extend credit.

ii. Reclamation claims

25. Consideration might also be given to allowing a supplier that sells goods on unsecured credit to reclaim the goods from the buyer within a specified period of time if the supplier discovers within that time that the buyer is insolvent. Although the supplier will want such period to be as long as possible to protect its interests, other creditors will be reluctant to provide credit based on assets subject to reclamation claims. Moreover, if the supplier is truly concerned about the credit risk, the supplier could insist upon a purchase money security right in the goods that it supplies on credit. Accordingly, although a reclamation claim is important so that suppliers can have some rights in the goods that they supply on unsecured credit, the reclamation period should be brief so that it does not impede lending generally. In addition, to avoid discouraging the availability of secured credit, reclamation claims relating to specific goods should not have priority over properly filed security rights in the same goods.

d. Buyers of encumbered assets

26. The grantor may also sell assets that are subject to existing security rights. In this situation the buyer 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 sold. It is important that a priority rule address both of these interests.

i. Sales outside the ordinary course of business of the grantor

27. In many countries, sales of encumbered assets outside the ordinary course of business of the grantor do not destroy any security rights that the secured creditor has in the assets, unless the secured creditor consents. In those jurisdictions, the secured creditor may, upon a default by the grantor, enforce its security right against the assets in the hands of the buyer. Without this protection, the rights of the secured creditor would be jeopardized any time that the grantor sells assets. This result would reduce the value of the encumbered assets as security, thereby impeding the availability of low-cost credit.

28. Even if the creditor would have a security right in the proceeds arising from the sale of the assets, the secured creditor would not necessarily be sufficiently protected, because proceeds often are not as valuable to the creditor as the original encumbered assets. In many instances, the encumbered assets may be sold in return for assets that have little or no value to the creditor as security. In other instances, it would be difficult for the creditor to identify the proceeds, and as result, its claim to the proceeds may be illusory. Also, there is a risk that the proceeds may be dissipated by the grantor, leaving the creditor with nothing.

29. As long as the creditor's security right is subject to filing in a reliable and easily accessible filing system, the buyer may protect itself by searching the filing system 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. Consideration might be given to whether any low-cost items should be exempted from this rule because the search costs imposed on potential buyers may not be justified for such items. On the other hand, 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 arbitrary line-drawing and would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors. As a result, it may be best not to provide for such an exemption.

30. In some countries that have a filing system that is searchable only by the grantor's name, rather than by a description of the encumbered assets, a purchaser who purchases the assets from a seller who previously purchased the assets from the grantor ("remote purchasers") obtains the assets free of the security rights granted by such grantor. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset, and accordingly, have no reason to conduct a search against the previous owner.

ii. Sales made in the ordinary course of business of the grantor

31. An exemption to the rule discussed in section A.3.d.i. above is generally provided for goods held as inventory of the grantor and sold in the ordinary course of the grantor's business. For such goods, there is a commercial expectation that the grantor will sell them (and indeed must sell them to remain viable), and that the buyer of the encumbered assets will take them free and clear of existing security

rights. Without such an exemption, a grantor's ability to sell goods in the ordinary course of its business would be greatly impeded, because buyers would have to investigate claims to the goods prior to purchasing them. This would result in significant transaction costs and would greatly impede ordinary course transactions.

32. As a consequence, many legal systems provide for an exception to the general rule of continuity of security rights in favour of buyers of encumbered assets if the sale is made in the ordinary course of the grantor's business and the asset being sold constitutes inventory of the grantor. To promote such ordinary course transfers, many legal systems provide that buyers in such transactions obtain the assets free and clear of any security right, even if the buyer had actual knowledge of the security right. This exception, however, is limited in some jurisdictions if the buyer had knowledge that the sale was made in violation of an agreement between the seller and its creditor that the assets would not be sold without the consent of the creditor.

e. Judgement or execution creditors

33. In many legal systems, a security right is extended to certain classes of creditors felt to be deserving of such a right. In particular, many legal systems give a security right to general unsecured creditors once they have reduced their claim to judgement and have caused the seizure of specific property.

34. In this situation, an existing creditor that has an earlier in time consensual security right in certain assets has an interest in making sure that its security right retains its priority over the security right obtained by a judgement, particularly with respect to assets it has already relied upon in extending credit. On the other hand, the judgement creditor has an interest in receiving priority with respect to assets that have sufficient value to serve as a source of repayment of its claim.

35. Many legal systems that have a filing system rank priority in this situation by time of filing of the security right, i.e. an earlier in time filed consensual security right in property will have priority over a subsequent security right in the same property obtained by judgement. Conversely, any attempt to grant a consensual security right in the property after a creditor has obtained some form of a judgement security right will result in an interest that is junior to the existing judgement security right. This approach is generally acceptable to creditors as long as the judgement security right is made sufficiently public so that creditors can become aware of it in an efficient manner and factor its existence into their credit decision before extending credit. To facilitate this, consideration should be given to subjecting judgement security rights to the general filing system for security rights, thus integrating them into the first-to-file priority regime.

36. There is generally an exception to this rule when it is applied to future advances (discussed in greater detail in section A.4.a. below). While a previously filed security right customarily will have priority over a judgement security right with respect to credit advanced prior to the date that the judgement security right becomes effective, it will generally not have priority over the judgement security right with respect to any credit advanced after such effective date (unless such credit had been committed prior to the effective date of the judgement). For example, in

example 2 (see A/CN.9/WG.VI/WP.2/Add.2, para. 10), Lender B makes loans from time to time to Agrico, which are secured by all of Agrico's receivables and inventory. If an unsecured creditor reduces its claim to a judgement against Agrico and thereby obtains a security right in Agrico's inventory, Lender B's security right in the inventory would have priority over the judgement security right with respect to loans that Lender B made prior to the date that the judgement became effective and for a specified period thereafter. However, the judgement security right would have priority with respect to any additional loans made by Lender B after the specified period (as long as Lender B did not commit prior to the effective date of the judgement to extend such additional loans).

37. To protect existing secured creditors from making additional advances based on the value of assets subject to judgement security rights, there should be some mechanism to put creditors on notice of such judgement security rights. In many jurisdictions in which there is a filing system, this notice is provided by subjecting judgement security rights to the filing system. If there is no filing system or if judgement security rights are not subject to the filing system, the judgement creditor might be required to notify the existing secured creditors. In addition, it may be provided that the existing secured creditor's priority continues for a period of time (perhaps forty-five to sixty days) after the judgement security right is filed (or after the creditor receives notice) so that the creditor can take steps to protect its interest accordingly. The less time an existing secured creditor has to react to the existence of judgement security rights and the less public such judgement security rights are made, the more their potential existence will impede the availability of credit facilities that provide for future advances.

f. Statutory (preferential) creditors

38. In many jurisdictions, as a means of achieving a general societal goal, certain unsecured claims are given priority over other unsecured claims, and in some cases, over secured claims (including secured claims that previously have been the subject of a filing). For example, to protect claims of employees and the Government, claims for unpaid wages and unpaid taxes often will, at some point, be given priority over previously existing security rights. Because societal goals differ from jurisdiction to jurisdiction, the types of these claims, and the extent to which they are afforded priority, also differ.

39. The advantage of establishing these preferential claims is that a societal goal may be furthered. The possible disadvantage is that these types of priorities can proliferate in a fashion that reduces certainty among existing and potential creditors, thereby impeding the availability of low-cost secured credit. To avoid discouraging secured credit, the availability of which is also a societal goal, the various societal goals should be carefully weighed in deciding whether to provide a preferential claim. Preferential claims should only be provided to the extent that there is no other effective means of satisfying the underlying societal goal and the impact on the availability of low-cost credit is acceptable. If preferential claims exist, the laws establishing them should be sufficiently clear so that a creditor is able to calculate the potential amount of the preferential claims and to protect itself.

g. Creditors adding value to or storing encumbered assets

40. Some legal systems provide that creditors who improve or fix encumbered assets, such as equipment repairers, have security rights in the encumbered assets they improve or fix, and that such security rights generally rank ahead of other secured claims in the encumbered assets. This priority rule has the advantage of inducing those who supply such value to continue in their efforts, and also has the advantage of facilitating the maintenance of the encumbered assets. As long as the amount that these security rights secure is limited to an amount that reflects the value by which the encumbered asset has been enhanced, such security rights and their elevated priority should be unobjectionable to existing secured creditors.

41. Some systems also provide that creditors who store encumbered assets, such as landlords and warehousemen, have security rights in the encumbered assets to secure the rental and storage obligations, and such security rights often rank ahead of other secured claims in the same encumbered assets.

42. In many jurisdictions, the rights described in the preceding two paragraphs are not subject to any filing requirement, and their existence can only be discerned through due diligence on the part of a prospective creditor. As a result, these security rights are often referred to as being “secret”. While secret security rights have the advantage of protecting the rights of the parties to whom they are granted without requiring such parties to incur the costs associated with filing, they pose a significant impediment to secured credit because they limit the ability of creditors to determine competing security rights. As discussed in Chapter V and Chapter VI (see A/CN.9/WG.VI/WP.2/Add.5, paras. ..., and Add.6, paras. ...), consideration should be given to requiring that notice of such security rights be filed in the security right filing system.

h. Insolvency administrators

43. It is particularly important that a secured creditor be able to determine what its priority will be in the event that an insolvency proceeding is commenced by or against its grantor, because there most likely will not be sufficient assets to pay all creditors and the secured creditor’s encumbered assets may be its primary, or only, source of repayment. As a result, in deciding to extend credit and in evaluating priority, secured creditors generally place their greatest focus on what their priority will be in an insolvency proceeding of the grantor. Therefore, it is important that the priority of a properly obtained security right not be diminished or impaired in an insolvency proceeding. The importance of this point in crafting an effective secured transactions law cannot be over-emphasized. To the extent that secured credit laws are not clear on this point, the willingness of creditors to provide secured credit will be seriously diminished.

44. In order to effectively compensate insolvency administrators for their work in the insolvency proceeding, they often are given a preferential claim in the assets of the insolvent estate. As long as the amount of this preferential claim can be determined by secured creditors in advance with a high degree of certainty, this claim is generally not objectionable to secured creditors, because they can take actions in advance to protect their claims. However, the greater this potential

preferential claim, the less value prospective secured creditors will attribute to the encumbered assets.

45. As discussed in greater detail in Chapter X (see A/CN.9/WG.VI/WP.2/Add.10, paras. ...), insolvency laws in many jurisdictions contain provisions that empower an insolvency administrator to challenge, within a limited period of time, the validity or priority of consensual security rights based upon factors such as lack of consideration to the grantor, the inequitable conduct of the creditor or the fact that the security right was granted in violation of a particular law. It is important to emphasize that any successful security regime must be meshed effectively with applicable insolvency laws so that a prospective creditor may properly structure its credit transaction in compliance with such laws in order to ensure that the effectiveness and priority of its security right is maintained in the case of the grantor's insolvency.

4. Priority in future advances and after-acquired property

a. Future advances

46. A secured creditor must be able to determine how much of its claim will be accorded priority. Some legal systems limit this priority to the amount of debt existing at the time of the creation of the security right. Other legal systems require publicity of the maximum amount of credit that will be extended priority. Yet other legal systems accord priority for all extensions of credit, even those made after creation of the security right.

47. The advantage of limiting priority to the amount of debt originally in existence at the time that the security right was created is that it matches priority with the contemplation of the parties at the time of creation, and preserves only that priority against creditors then in existence. The disadvantage of this approach is that it requires additional due diligence (e.g. searches for new filings), and additional agreements and filings for amounts subsequently advanced. This is particularly problematic because one of the most effective means of providing secured credit is on a revolving basis because this type of credit facility most efficiently matches the grantor's particular borrowing needs (see example 2 in A/CN.9/WG.VI/WP.2/Add.2, paras. 8-10, and Add.4, para. 10). Accordingly, consideration might be given to affording to future advances the priority afforded to advances made at the time that the security right is first created.

48. To avoid tying up all the grantor's assets with one creditor, thus reducing willingness with which subsequent creditors may extend credit to the grantor, many legal systems require that security right filings set forth a maximum amount of debt that may be secured by any given security right, and limit priority to such maximum amount (see A/CN.9/WG.VI/WP.2/Add.6, paras. ...). To avoid hindering the advancement of revolving credits as discussed above (see para. 47) or any other similar form of credit, consideration might be given to not limiting the amount to which future advances are afforded priority.

b. After-acquired property

49. As discussed in greater detail in Chapter IV (see A/CN.9/WG.VI/WP.2/Add.4, paras. 19-23), in some legal systems a grantor may provide for a security right in property to be acquired in the future. Such a security right is obtained simultaneously with the grantor's acquisition of the property, without any additional steps being required each time additional property is acquired. As a result, the costs incident to the grant of a security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory, which is acquired for resale, receivables, which are collected and re-generated on a continual basis (see example 2 in A/CN.9/WG.VI/WP.2/Add.2, paras. 8-10) and equipment, which is replaced in the normal course of the grantor's business.

50. The allowance of security rights in after-acquired property raises the question of whether the priority dates from the time of the initial grant or from the time the grantor acquires the property. Different systems address this matter in different ways. Some systems vary the effect depending on the status of the creditor competing for priority (with priority dating from the date of the grant *vis-à-vis* other consensual security creditors, and from the date of acquisition *vis-à-vis* all other creditors). Whatever the rule, it is important that it be clear so that creditors can protect their interests accordingly.

5. Priority in proceeds

51. If the creditor has a right in proceeds of the original encumbered asset, issues will arise as to the status and priority of that right as against other competing claimants. Apart from the competing claimants mentioned already, competing claimants with respect to proceeds may include a creditor of the debtor who has obtained a right by judgement or execution against the proceeds and another creditor who has a security right in the proceeds.

52. A security right in proceeds can arise in two ways. The debtor may have granted the competing secured creditor a security right in the proceeds after the debtor acquired the proceeds; or the proceeds are a type of property in which the competing secured creditor has a pre-existing interest that covers after-acquired or future collateral. For example, creditor A has a security right in all of the debtor's inventory and creditor B has a security right in all of debtor's receivables (including future receivables). Assume further that the debtor later sells inventory that is subject to the security interest of creditor A and that this sale is on credit. The receivable generated by the sale is proceeds of the encumbered asset of creditor A and is the encumbered asset of creditor B.

53. The legal system governing security rights must answer several questions with respect to the claim of the secured creditor as against each of the above-mentioned competing claimants. The first question is whether the right of the secured creditor in the proceeds of its initial encumbered asset is effective not only against the grantor but also against competing claimants. The answer to this question must be affirmative, at least in some circumstances. Otherwise, the value of encumbered assets would be largely illusory. Security rights add economic

security (thereby increasing access to credit at lower cost) only in cases in which the security right provides the creditor with the right to apply the value of the encumbered asset to the debt owed to the creditor before that value is applied to claims of other claimants.

54. Nonetheless, it must be recognized that the creation of a right in proceeds raises important concerns about the risks created for third parties. In particular, considerations that lead to a requirement of publicity for a security right in particular property to be effective against third parties may lead to a conclusion that similar requirements are appropriate for the right in proceeds.

55. Therefore, a legal regime should contain rules that determine when the publicity that is given to the security right in the original encumbered asset will suffice to publicize the creditor's right in the proceeds. In cases in which a different mode of publicity is required for the creditor's interest in the proceeds, the legal regime should provide a period of time after the transaction generating the proceeds in which the creditor may provide the publicity without losing its interest in the proceeds.

56. While determination of whether a new act of publicity is necessary in order for the creditor's right in proceeds to be effective against third parties is quite important, that determination alone is not sufficient to resolve the relative rights of the secured creditor's right in proceeds. In particular, priority rules are needed to determine the relative priority of the secured creditor's right.

57. The priority rules may differ depending on the nature of the competing claimant. For example, if the competing claimant is another secured creditor whose rights are also dependent on publicity, the rules determining the relative priority of the rights of the two secured creditors might depend on the nature and timing of the publicity. Priority may depend on other factors when the competing claimant is a judgement creditor or an insolvency administrator (see paras. 33-37).

58. In many cases in which the competing claimant is another secured party, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to the original encumbered asset and the policies that generated those rules. For example, in a legal system in which the first right in particular property that is publicized has priority over competing rights, that same rule could be used to determine the priority when the original encumbered asset has been transferred and the secured creditor now claims a right in proceeds. If the right in the original encumbered asset was publicized before the right of the competing claimant in the proceeds was publicized, that right could be given priority.

59. In cases in which the order of priority of competing interests in the original encumbered asset is not determined by the order of publicity, a separate determination will be necessary for the priority rule that would apply to the proceeds of such original encumbered asset. This might be the case, for example, if one of the competing rights in the original encumbered asset is a security right securing the purchase price of the encumbered asset and, accordingly, awarded higher priority than would otherwise be the case.

6. Voluntary alteration of priority: subordination agreements

60. The priority enjoyed by any secured creditor need not be unalterable. In many systems, priority may be, and frequently is, altered by private contract. As an example, a lender with a security right in all existing and after-acquired assets of a grantor could agree that the grantor might give a first priority security right in a particular asset so that the grantor could obtain additional financing from a source other than the lender based on the value of that asset.

61. Such agreements altering priority are perfectly acceptable as long as they affect only the parties who actually consent to such alterations. Subordination agreements should not affect the rights of creditors who are not parties to the agreement. Additionally, it is important that the priority afforded by a subordination agreement continue to apply in an insolvency proceeding of the grantor.

7. Relevance of priority prior to enforcement

62. Another important issue pertaining to priority is whether priority only has relevance after the occurrence of an event of default by the grantor in the underlying obligation or whether priority also has relevance prior to default. Many jurisdictions allow the holder of a junior consensual security right to receive a regularly scheduled payment on its obligation *before* the secured obligation having priority is paid in full, absent a contrary agreement between the senior and junior claimant. If the junior claimant were to be required to remit the payment, this would be a major impediment to the junior claimant providing financing.

63. The result may be different if the junior claimant received proceeds from the collection, sale or other disposition of the collateral. In that circumstance, some jurisdictions require the junior claimant to remit the proceeds to the senior claimant if the junior claimant received the proceeds with the knowledge that the grantor was required to remit them to the senior claimant. The rationale behind this rule is similar to the rationale discussed in section A.3.d. above with respect to buyers of encumbered assets.

B. Summary and recommendations

64. The concept of priority is a critical component in any secured lending regime that seeks to promote the availability of low-cost secured credit. The availability of credit is dependent on the ability of creditors to determine, with a high degree of certainty prior to extending credit, what their priority will be if they attempted to realise their security. Because such realisation often occurs in an insolvency proceeding of the grantor, it is critical that a secured creditor's priority continue unimpaired in the insolvency proceeding.

65. It is therefore important that secured lending laws include priority rules that are clear and lead to predictable outcomes. These rules should allow all creditors, even unsecured creditors, to assess their positions in advance of extending credit and to take steps to protect their interests. Clear priority rules that result in

predictable outcomes and efficient mechanisms for ascertaining and establishing priority at the time credit is advanced may be more important to creditors than the particulars of the priority rule itself.

66. This result may be achieved most effectively by establishing a filing system and basing priority according to the first to file a notice of a security right. In addition, assuming that the filing system is reliable and easily accessible, it may provide an effective mechanism for alerting creditors to competing security rights.

67. Exceptions to the first-to-file priority rule should only be considered to the extent that there is no other means to satisfy the underlying policy objective of the exception and that objective justifies the impact of the exception on the availability of low-cost credit. Any such exceptions should be stated clearly, allowing creditors to assess the likelihood of any preferential claims and to take steps to protect themselves with respect to such claims. In order to most effectively alert creditors as to competing claims, consideration should be given to subjecting all claims, including preferential claims, to the security right filing system. Some important exceptions to the first-to-file priority rule that should be addressed in crafting secured transactions laws pertain to purchase money security rights, creditors that add value to collateral (such as equipment repairers) and possibly also certain claimants (such as wage and Governmental claimants) that legislatures may wish to protect to achieve general societal goals.

68. Recognizing priority with respect to future advances and after-acquired property is likely to encourage the availability of revolving and other similar credits to businesses. The simpler the procedure for a creditor to establish priority with respect to future advances and after-acquired property, the greater will be the availability of these credits.

69. At least, in certain circumstances, the right of the secured creditor in the proceeds of its encumbered assets should be effective not only as against the grantor but also as against competing claimants. A legal regime should provide when a publicity act with respect to the security right suffices to publicize the creditor's rights in the proceeds or when a new publicity act is required. In addition, a legal regime should include priority rules with respect to rights in proceeds. Such rules may differ depending on the nature of the competing claimant.

70. Regardless of the priority rules of any secured transactions regime, creditors should be permitted to vary such rules by private contract in order to structure financing arrangements that best suit the grantor's needs. Such agreements should be recognized as effective among the parties thereto in an insolvency proceeding commenced by or against the grantor; however, they should not affect the rights of persons who are not parties to such agreements.

71. Finally, secured transactions regimes should specify the circumstances in which the holders of junior security rights in specific encumbered assets will be prevented from taking actions that are inconsistent with the rights of the holders of senior security rights in the same assets. Examples of such actions include retaining proceeds from the sale or other disposition of such assets with knowledge of the grantor's contractual obligation to remit those proceeds to the senior secured creditor.

General AssemblyDistr.: Limited
13 March 2002

Original: English

**United Nations Commission
on International Trade Law**

Working Group VI (Security Interests)

First session

New York, 20-24 May 2002

Security Interests**Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-43	2
VIII. Pre-default rights and obligations of the parties	1-43	2
A. General remarks	1-35	2
1. Introduction	1-4	2
2. Party autonomy	5-9	3
a. The principle	5-6	3
b. Limitations	7-9	3
3. Default rules	10-35	4
a. Meaning	10-11	4
b. Policy objectives	12-13	4
c. Types of default rules	14-35	5
B. Summary and recommendations	36-43	8

VIII. Pre-default rights and obligations of the parties

A. General remarks

1. Introduction

1. The legal requirements for a valid and enforceable security agreement are minimal and should be easily satisfied (see A/CN.9/WG.VI/WP.2/Add.4, paras. 36-46). However, efficiency and predictability call for the incorporation of additional terms into the security agreement aimed at covering other aspects of the transaction. For example, revenues deriving from the encumbered assets may be retained by the secured creditor and increase the value of the encumbered asset or may contribute to the payment of the secured obligation. The parties themselves are in the best position to tailor the terms of the security agreement to their own needs and wishes. However, to fill gaps that may arise if the parties do not include additional terms, secured transactions regimes normally include a set of default rules detailing the parties' rights and obligations before default.

2. The legislative imposition of default rules is necessary for an effective, efficient and responsive legal framework governing security rights in movable property. Comprehensive coverage, clarifying the position of the parties by filling potential gaps in the security agreement, constitutes a core principle for an effective regime of secured transactions in personal property, or at least one of its most important corollaries (see A/CN.9/WG.VI/WP.2/Add.1, paras. 11 and 17). In this regard, the Guide pursues a policy shared by many recent legislative reforms (e.g. Quebec Civil Code and art. 9 UCC), regional model laws (e.g. the EBRD and the OAS Model Laws), and international conventions dealing with some aspect of secured transactions in movable assets (e.g. the Assignment Convention and the Mobile Equipment Convention).

3. There are two limitations to the scope of this Chapter. Firstly, it does not deal with the terms required to create a security agreement (e.g. the minimum contents of the security agreement), since they fulfil a different function and are, therefore, addressed in Chapter IV. Secondly, it does not deal with the rights and obligations of the parties to the security agreement after default, since after default different policy issues arise that are addressed in Chapter IX.

4. The initial discussion below is focused on two important policy issues. The first relates to the principle of party autonomy and the extent to which the parties should be free to fashion their own security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second relates to the type and number of default rules to be included, so as to encompass new and evolving forms of secured transactions. The Chapter concludes by outlining recommended pre-default rights and obligations of both the secured creditor and the debtor.

2. Party autonomy

a. The principle

5. To the extent that consumer-protection legislation is not interfered with, party autonomy may be established as a cardinal principle governing the relationship of the parties to the security agreement before default. Adopting party autonomy as a governing principle covering the non-proprietary aspects of secured transactions favours contractual flexibility. While this empowers credit providers with significant choice in fashioning the security agreement, the goal, ultimately, is to provide debtors with wider access to credit at a lower cost.

6. Allowing ample room for contractual flexibility would also contribute to the regulation of transactions between the parties in the longer term, by filling potential gaps in the security agreement. In many cases the security agreement is not regarded as a static, one-shot transaction. The parties may anticipate a dynamic, ongoing financing relationship in which additional funds will be loaned by the secured creditor and property to be acquired in the future by the debtor will be offered as security. Requiring the parties to formalize all subsequent modifications and additions to their initial agreement would impose significant compliance costs, which would ultimately be borne by the debtor. Party autonomy would allow the parties to protect their legitimate interests in secured transactions that form part of a longer-term relationship.

b. Limitations

7. As it is not possible to foresee all the circumstances in which a security right may be required to secure the performance of an obligation, it is advisable to avoid unnecessary restrictions which may hinder the ability of the parties to adapt a secured transaction to their own needs and circumstances. There must be, however, some limitation of party autonomy to prevent overreaching by the secured creditor. Those limits should be clearly drawn on grounds of public policy (*ordre public*) and an overriding principle of good faith and fair dealing, narrowly tailored to prevent any perverse or dysfunctional allocation of burdens in the name of party autonomy.

8. Whereas the secured creditor and debtor should be mostly free to deal with their mutual contractual rights and obligations, such freedom does not extend to the proprietary effects of the security agreement that may impact the rights and obligations of third parties. The notion of party autonomy in this context should be understood within the limits imposed by the wider field of property law.

9. Aside from such reasonable limits, which each jurisdiction will determine on criteria of their own, the parties should be given wide flexibility to:

- (i) agree upon the terms of the security agreement;
- (ii) define the obligation to be secured and the events triggering its default;
- and
- (iii) determine what the debtor can and can not do with the encumbered assets.

3. Default rules

a. Meaning

10. The rules included in this Chapter are meant to apply automatically in the absence of evidence that the parties intended to exclude them. The conceptual vocabulary used to identify rules “subject to agreement otherwise” varies from country to country (e.g. *jus dispositivum*, *lois supplétives*, non-mandatory rules). These terms, however, have a common purpose as gap-filling law, in the sense that the rule applies only to the extent that the parties have failed to cover the point in their agreement. Whatever the language chosen to formulate these rules, it should make clear that they apply and are enforceable on the condition that the parties did not agree otherwise.

11. As to the number of default rules to be included, the Guide does not include an exhaustive list of the rights and obligations of the parties during the lifetime of the secured transaction. Whereas the law might set forth those rules on which the parties themselves would be most likely to agree, the list of default rules are not meant to operate as a substitute for a standard form. The default rules should cover only the most normal or regular incidents arising during the course of a secured transaction, i.e. the rights and obligations that the legislator fairly infers the parties had assumed despite the absence of an express term in the security agreement.

b. Policy objectives

12. All of the default rules should pursue plausible policy objectives, such as the reasonable allocation of responsibility for caring for the encumbered asset, the preservation of its pre-default value and the maximization of its post-default value. Additional terms in the security agreement, to enhance the protection of secured lenders or debtors, are better left to the parties’ initiative without the need to incorporate them as default rules in the law envisaged by this Guide. For example, if the parties would like to include a choice-of-law clause, or if the secured creditor would like the debtor to deposit any insurance proceeds in a given deposit account, or if the debtor who retains possession of the encumbered assets would like to receive a certain advance notice before the secured creditor exercises its right to inspect them, the contracting parties must expressly contract for those additional terms.

13. The default rules might pursue a set of policies fitting the needs and practices of each jurisdiction. However, most jurisdictions are likely to agree on the advantages of adopting default rules on personal property security that are conducive to widening access to credit at a lower price. For example, the party in possession of the encumbered asset should have a duty of preservation and care. This type of rule is meant to encourage responsible behaviour on the part of those having control and custody of the encumbered assets, while at the same time maximizing the realization value of the encumbered assets in the case of default.

c. Types of default rules

14. A distinction may be drawn between those rights and obligations that are common to a secured creditor in possession of the encumbered asset and those pertaining to the debtor in possession of the encumbered assets in the case of non-possessory security.

i. Possessory security

15. In the context of possessory security rights, the pre-default rights and obligations of the parties should at the very least encourage the secured creditor to preserve the value of the encumbered assets, especially if those assets represent income-producing property. The following are among the most important duties and rights conferred on a secured creditor in possession of the encumbered assets.

(a) Duty of care

16. The best way to encourage responsible behaviour on the part of the secured creditor in possession is to impose on the creditor an obligation to take reasonable care of the encumbered asset. The scope and mode of exercise of this duty of care should be clearly stated, in detail. This should include a duty to preserve or maintain the encumbered asset in good condition, as well as to undertake all necessary repairs to keep that asset in good condition.

17. Depending on the circumstances, the duty of care may be discharged in different ways. In some cases, it may be enough for the secured creditor to notify the debtor, giving the encumbered asset back to the debtor, so that the debtor can undertake the acts of preservation. In other cases, the debtor may not be reasonably expected to undertake such acts and it is the secured creditor in possession who must carry out this duty of care.

(b) Right to be reimbursed for reasonable expenses

18. Those expenses that are reasonably incurred in pursuance of the secured creditor's duty of care should be borne by the debtor and the secured creditor should have the right to be reimbursed by the debtor for those expenses. Other types of expenses that the secured creditor chooses to incur should not be chargeable to the debtor.

(c) Right to make reasonable use of the encumbered asset

19. In order to encourage the profitable use of the encumbered asset, the secured creditor should be allowed to make use of or operate the encumbered asset for the purpose of its preservation and maintenance, although always in a manner and to the extent that such use is reasonable.

(d) Duty to keep the encumbered assets identifiable

20. Unless the encumbered assets are of a fungible nature, the secured creditor must keep tangible assets in an identifiable form.

(e) Duty to take steps to preserve the debtor's rights

21. The secured creditor's duty of care of assets, such as the right to payment of money, intellectual property rights and other intangible movables, does not merely consist of the preservation of the document or instrument which embodies such right to payment or intellectual property right. The duty of care in these cases extends to an obligation to take active steps to maintain or preserve the debtor's rights against those who are secondarily liable (e.g. a guarantor).

(f) Duty to allow inspection by debtor

22. An additional obligation of the secured creditor in possession is to allow the debtor to inspect the encumbered assets at reasonable times.

(g) Right to impute revenues to the payment of the secured obligation

23. Proceeds (including monetary profits, the offspring of animals and other "civil" or "natural" fruits) derived from the encumbered asset and received by the secured creditor may, unless remitted to the debtor, be retained by the secured creditor and imputed to the payment of the secured obligation.

(h) Right to assign the secured obligation and the security right

24. A secured creditor should be entitled to assign both its payment claim against the debtor ("secured obligation") and the security right attached to that secured obligation. Where this is possible, the assignee succeeds to all the rights vested in the original secured creditor.

(i) Right to "repledge" the encumbered asset

25. The secured creditor may also be entitled to create a security right in the encumbered asset as security for a debt. That is, the secured creditor may "repledge" the encumbered asset as long as the debtor's right to get the asset back when it fulfils its obligation is not impaired.

(j) Right to insure against loss or damage of the encumbered asset

26. The risk of loss or deterioration of the encumbered assets remains on the debtor despite the creation of a security right (in most legal systems the debtor retains a property right in the encumbered asset). Yet, it is in the interest of the secured creditor to keep the encumbered asset insured in full. Therefore, the secured creditor should be entitled to contract insurance on behalf of the debtor and be reimbursed for that expense.

(k) Right to pay taxes on behalf of the debtor

27. Taxes assessed against the encumbered assets also fall under the responsibility of the debtor. However, a secured creditor should be entitled to pay those taxes on the debtor's behalf to protect its security right in the assets. Such payment should be

regarded as a reasonable charge incurred in the preservation of the encumbered asset for which the secured creditor should be entitled to reimbursement.

ii. Non-possessory security

28. As a key policy objective of an effective secured transactions regime, a secured transactions regime should encourage responsible behaviour by the debtor who remains in possession of the encumbered asset while having granted a security right over those assets (see A/CN.9/WG.VI/WP.2/Add.1, para. 18). Accordingly, the policies underlying the default rules for non-possessory security are aimed at maximizing the economic potential of the debtor's assets (see A/CN.9/WG.VI/WP.2/Add.1, para. 11). Encouraging the economic utilization of the debtor's assets facilitates the generation of revenue for the debtor. Maintaining the pre-default value of the encumbered assets belonging to the debtor is consistent with the objective of maximizing the realization value of those assets for the benefit of the secured creditor.

(a) Duty to keep the encumbered assets properly insured and to pay taxes

29. The duty of care allocated to the debtor in possession includes keeping the encumbered asset properly covered by insurance and making sure that the property taxes are punctually paid. If these pre-default expenses are incurred by the secured creditor, its right to be reimbursed by the debtor is secured by the security right.

(b) Duty to allow the secured creditor to inspect

30. The secured creditor should have the right to police the conditions in which the encumbered asset is kept by the debtor in possession. To this effect, the debtor should be bound to allow the secured creditor to inspect the encumbered assets at all reasonable times.

(c) Duty to account and to keep adequate records

31. When the encumbered assets consist of income-producing property in possession of the debtor, the debtor's duties include the reasonable rendering of accounts regarding the disposition and handling of the proceeds derived from the encumbered assets. This duty should include maintaining adequate bookkeeping records regarding the status of the encumbered assets.

(d) Duty to take steps to preserve rights in the encumbered assets

32. In the case of intangible encumbered assets, such as the debtor's right to payment in the form of receivables, deposit accounts, royalties or rights on account of patents, copyrights, and trademarks, the main aspect of the debtor's obligation of care includes the taking of necessary steps to preserve those rights.

(e) Right to receive revenues

33. In the same way that the debtor is responsible for pre-default expenses and charges, the debtor also receives the benefits from revenue and proceeds derived

from the encumbered asset in the debtor's possession. These proceeds are typically made subject to the security right held by the secured creditor in the encumbered assets.

(f) Right to use, mix, commingle and process the encumbered asset

34. The debtor in possession is typically entitled to use, mix or commingle and process the encumbered asset with other assets, as well as to dispose of the encumbered assets in the ordinary course of its business.

(g) Right to grant another security right in the same asset

35. The power of the debtor to confer a subsequent security right over an already encumbered asset, should also be included as a default right.

B. Summary and recommendations

36. The default rules included in this Chapter seek to clarify the pre-default rights and obligations of the parties to the security agreement. These rules are permissive rather than mandatory, so that the expression, "unless otherwise agreed", should be read as a preamble to each of the rights and duties allocated to the parties. A corollary of the permissive nature of these rules is that the parties may waive or vary the rights and obligations allocated to them in this Chapter, unless such waiver is against public policy or in conflict with an overriding principle of good faith and fair dealing.

37. A secured creditor in possession of the encumbered asset should care, preserve and maintain the asset in good condition. The secured creditor is also bound to undertake all necessary repairs to keep the encumbered asset in such condition. In case of tangible encumbered assets, the secured creditor should keep those assets properly identifiable, unless they are fungible movables.

38. Where the encumbered asset consists of the debtor's right to the payment of money or other intangible assets (e.g. negotiable instruments or receivables), the obligation of care on part of the secured creditor should include the duty to preserve the debtor's rights against persons secondarily liable. The secured creditor should allow the debtor to inspect the encumbered asset at all reasonable times. Upon full satisfaction of the secured obligation, the secured creditor should return the encumbered asset to the debtor.

39. The secured creditor in possession should be entitled to retain as additional security any proceeds deriving from the encumbered asset and to impute it to the payment of the secured obligation unless remitted to the debtor. The secured creditor may also create a security right in the encumbered asset by repledging it.

40. Reasonable expenses incurred by the secured creditor while discharging the obligation of custody and care (including the cost of insurance and payment of taxes) must be reimbursed to the secured creditor. The secured creditor's right to be reimbursed for those expenses should also be secured by the encumbered asset.

41. In the context of non-possessory security, the debtor who remains in possession of the encumbered assets should also be bound by a duty of custody and preservation. In fulfilling this duty, the debtor is bound to incur expenses such as insurance premiums, taxes and other charges.

42. The debtor in possession should be entitled to use, mix or commingle and process the encumbered asset with other assets, as well as to dispose of the encumbered assets in the ordinary course of business. The debtor may also grant a subsequent security right in the encumbered asset.

43. The debtor in possession should also be bound to allow the secured creditor to police the conditions of the encumbered assets at reasonable times and to keep reasonable bookkeeping practices detailing the disposal or handling of the encumbered assets. If the encumbered asset consists of intangible movable property, the debtor's obligation of care extends to asserting or defending the debtors right to be paid, or to take the steps that are necessary to collect what is due to the debtor.

General AssemblyDistr.: Limited
11 April 2002

Original: English

**United Nations Commission
on International Trade Law**Working Group VI (Security Interests)
First session
New York, 20-24 May 2002**Security Interests****Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum*****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-48	2
IX. Default and enforcement.	1-48	2
A. General remarks	1-40	2
1. Introduction.	1-4	2
2. Key objectives	5-11	3
3. Default.	12-16	4
a. The meaning of default	12	4
b. Cure of default.	13	5
c. Notice of default	14-15	5
d. Judicial or administrative review	16	6
4. Options following default	17-40	6
a. Judicial action to enforce the security right	19-24	6
b. Freedom of parties to agree to the enforcement procedure	25	7

* This addendum is submitted four weeks less than the required ten weeks prior to the start of the meeting because the secretariat of the Commission was fully occupied with the preparation of other documents, including another eleven addenda of A/CN.9/WG.VI/WP.2, ten of which have already been submitted.

c. Acceptance of the encumbered assets in satisfaction of the secured Obligation	26-27	8
d. Redemption of the encumbered assets	28	8
e. Authorized disposition by the grantor	29	8
f. Removing the encumbered assets from the grantor's control	30-31	8
g. Sale or other disposition of the encumbered assets	32-34	9
h. Allocation of proceeds of disposition	35-36	9
i. Finality	37	10
j. Variations on general framework	38-39	10
5. Judicial proceedings brought by other creditors	40	10
B. Summary and recommendations	41-48	10

IX. Default and enforcement

A. General remarks

1. Introduction

1. This Chapter examines the secured creditor's enforcement of its security right if the debtor fails to perform ("defaults on") a secured obligation without being insolvent (insolvency is dealt with in Chapter X).

2. A reasonable secured creditor expects a debtor to perform its obligations without the need for the creditor to have recourse to encumbered assets. A reasonable debtor will also expect to perform. Both will recognize, however, that there will be times when the debtor will not be able to do so. The failure may result from poor management or business misjudgements, but it may also be for reasons beyond the debtor's control, such as an economic downturn in an industry or more general economic conditions.

3. Reasonable creditors will periodically review their debtors' business activities or the encumbered assets and communicate with those debtors who show signs of having financial difficulties. Reasonable debtors will cooperate with their creditors to work out ways to overcome these financial difficulties. Creditors and debtors working together may enter into "composition" or "work out" agreements, that extend the time for payment, reduce the debtors' obligation or modify security agreements. Negotiations to reach a composition agreement take place in the shadow of two principal legal factors: the secured creditor's right to enforce its security rights if the debtor defaults on its secured obligation and the possibility that insolvency proceedings will be initiated against the debtor.

4. At the heart of secured transactions regime is the right of the secured creditor to look to the value of the encumbered assets to satisfy the secured obligation if the debtor defaults. The availability and the cost of credit will be affected by the amount of the estimated proceeds of the disposition of the encumbered assets. The costs of realizing the value of a security right are also costs that the creditor will include when calculating the amount and cost of credit it is willing to extend to the debtor.

2. Key objectives

[Note to the Working Group: The Working Group may wish to consider whether this section should be retained and developed within this Chapter or whether any substantive discussion of objectives should be contained in Chapter II. If the latter approach is taken, there are some similarities between (i) and (iv) below, and objectives A and G in Chapter II, though Chapter II may otherwise require some amendment to accommodate the points made here].

5. Consistent with the key objectives of an efficient regime outlined in Chapter II, a secured transactions regime should have the following specific objectives for a default and enforcement procedure:

(i) Provide clear, simple and transparent legal rules for the enforcement of security rights following a debtor's default, and for the post-default rights, obligations and priorities of interested parties

6. A secured transactions regime should provide procedural and substantive rules for the enforcement of a security right after a debtor has defaulted. These rules should permit the parties to determine what is to be done with the encumbered assets and the allocation of the proceeds of any disposition of the encumbered assets. They should also deal with any deficiency or surplus (i.e. the difference between the monetary value of the secured obligation and the proceeds of any disposition of the encumbered assets), which may be due from or to the debtor. These legal rules should be clear, simple and transparent to ensure certainty about the likely outcome of enforcement proceedings. A secured creditor will, otherwise, incorporate the added risk, created by any uncertainty, into the cost of credit it extends.

(ii) Maximize the realization value of the encumbered assets in a manner consistent with protection of the rights of interested parties and the public

7. All interested parties (i.e. the secured creditor, the debtor, the grantor and other creditors) benefit from maximizing the amount that will be realized by disposing of the encumbered assets after the debtor has defaulted. The secured creditor benefits if any deficiency the debtor may owe as an unsecured debt is reduced. At the same time, the debtor or grantor and the debtor's other creditors benefit, either by a smaller deficiency or by a larger surplus. A secured transactions regime may maximize the value realized by decreasing the transaction costs of the disposition, thus increasing the amount of the proceeds received on disposition of the encumbered assets.

8. Any procedures implemented should be consistent with the need to protect the rights of interested parties and the public. The key issue for a secured transactions regime is what modifications, if any, should be made to the normal rules for debt collection. Some regimes, for example, provide for expedited court proceedings. Other regimes delegate to the secured creditor the authority to take possession of the encumbered assets and dispose of them with no direct government or independent administrative intervention. Expedited procedures and delegation of authority, however, should take into account the right of persons to be heard in protection of legitimate claims to encumbered assets. Moreover, the allocation of resources within the judicial system and any delegation to private persons necessarily raise issues of public interest.

(iii) Provide transactional finality upon compliance with the enforcement procedure

9. After the process for realizing the value of the security right is completed, there should be finality. The secured creditor's security right in the encumbered assets should terminate. If the encumbered assets have been disposed of, the grantor's rights in the assets should also terminate. The law should also determine whether the security rights of other secured creditors in the encumbered assets continue notwithstanding disposition of the assets in the enforcement procedure. In this respect, the law may distinguish between senior and junior security rights (i.e. whether or not other secured creditors have priority over the security right of the creditor initiating enforcement).

(iv) Define clearly the extent to which the secured creditor and the grantor may agree on the procedure for realization of the value of the encumbered assets

10. The principle of freedom of contract rests upon the assumption that self-interested parties are the best judges of the value of a proposed contractual exchange. The aggregate of these contractual exchanges leads to an efficient allocation of resources within an economy. This principle must be balanced with the further principle that a bilateral contract should not affect adversely the rights of third parties or the public interest in such matters such as abuse of rights. In the context of a regime for enforcement of security rights, the law must define the extent to which the secured creditor and debtor may agree on the procedure to be followed. In particular, the law may distinguish between those legal rights that can be modified in the original security agreement and those that can be modified only after default.

(v) Coordinate the enforcement rights and procedures of the security right regime with the rights and procedures for security rights in insolvency proceedings

11. A security right is of particular importance to a secured creditor when the debtor is in financial difficulty. A debtor who is in financial difficulty is more likely to default on its obligations and may end up voluntarily or involuntarily in insolvency proceedings. If the value of a security right in insolvency proceedings is less than the value of that right outside such proceedings, the debtor and other creditors will have an incentive to precipitate the insolvency proceedings. A secured creditor subject to such a regime will, when extending credit, take into account the diminished value of the security right in insolvency proceedings and will reduce the credit extended or increase the costs of the credit to the debtor. Provision for recognition and enforcement of security rights within the insolvency process will create certainty and facilitate the provision of credit (for a discussion of enforcement of security rights in insolvency proceedings, see Chapter X).

3. Default

a. The meaning of "default"

12. If a debtor fails to perform a secured obligation the debtor is in "default". The parties' agreement and the general law of obligations will determine whether there has been a default. A loan agreement, for example, may list events of default

that make the loan immediately repayable. The security agreement will usually define what constitutes default. In the unlikely case where the parties' contracts are silent, general principles of contract law establish whether a debtor has defaulted. A law governing secured transactions, therefore, need not define default. If a definition is included, it is sufficient to state that a default occurs when the debtor fails to perform a secured obligation, or is otherwise in default as defined by the security agreement or other law.

b. Cure of default

13. Whether the law should permit a debtor to cure or correct a default requires weighing protection of the debtor when default does not evidence a long-term inability to perform against protection of the creditor from the costs of delayed performance and a cycle of default-cure. Although this issue of curing or correcting default could be left to the general law of obligations or special debtor protection legislation, the potential removal of the encumbered assets from the control of the debtor may focus attention on the issue in the context of a secured transactions law. A secured transactions law that addresses the issue of cure of default should ensure that it is consistent with existing law and should provide explicit cross-references to legislation that it does not displace to ensure transparency.

c. Notice of default

14. The debtor's default is a precondition to the secured creditor's right to enforce its security right against the encumbered assets. A secured transactions law should address whether notice of the default should be given and to whom. The principal benefit of a notice is that it permits the debtor and other interested parties to protect their interests. A debtor, for example, may challenge whether default has occurred and, if the law so provides, seek to cure the default or to redeem the encumbered assets. Notice to other interested parties allows them to monitor subsequent enforcement by the secured creditor and, if they are secured creditors whose rights have priority, to take control of the enforcement process. The disadvantages of notice include its cost, 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 dismember the debtor's business. Although some secured transactions laws do not require notice of default, many do so.

15. As with other situations where notice may be necessary, a secured transactions law should spell out the minimum contents of a notice, the manner in which it is to be given and its timing. When doing so, the law might 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. The secured creditor might, for example, be required to give prior written notice to the debtor and grantor followed by filing a notice in a public register. The creditor might also be required to give written notice to those other secured creditors who have filed notice of their interests or who have otherwise notified the creditor. Alternatively, the registrar might be required to give such notice. As for the information to be included in the notice, the law might require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default and detail the steps the debtor or grantor may take to cure the default or to redeem the encumbered assets. The secured creditor may also be required to elect, at least provisionally, the steps it intends to take to enforce its security right.

d. Judicial or administrative review

16. To ensure the integrity of the enforcement procedure, the debtor and other interested parties should have an opportunity to have judicial or administrative review of acts of the secured creditor. The debtor should have an opportunity to challenge the secured creditor's position that there has been a default, or the calculation of the amount owing as a result of the default. To avoid unduly delaying rightful enforcement, the review should be expedited. Safeguards should be built into the process to discourage debtors from making unfounded claims to delay the enforcement.

4. Options following default

17. Most legal systems recognize that a secured creditor may enforce the secured obligation by judicial action following the same procedure used to enforce any claim. If judgement is rendered on the secured obligation, the judgement may then be executed in the same way on any of the debtor's assets available to creditors, including the encumbered assets. The discussion in the following paragraphs focuses, however, on enforcement of the secured creditor's security right in the encumbered assets, whether by judicial action or otherwise.

18. When the debtor defaults, the secured creditor may or may not be in possession of the encumbered assets. A secured creditor in possession is protected against potential abuse (e.g. hiding or misusing the assets) by the debtor or grantor. A secured transactions regime should protect the non-possessing secured creditor from such abuse as well. Leaving aside the issue of protection against potential abuse, however, there is no reason to distinguish between a creditor with a possessory security right and other secured creditors, and the same procedures for realizing the value of the security right may be applied to all secured creditors.

a. Judicial action to enforce the security right

19. A key issue for a secured transactions regime is the extent to which the secured creditor must resort to the courts or other authorities (e.g. bailiffs, notaries or the police) to enforce its security right.

20. In order to protect the debtor and other parties with rights in the encumbered assets, many legal systems require the secured creditor to resort to the courts or other authorities to enforce its security right. However, this approach may inadvertently result in delays and costs that the debtor may have to ultimately bear, because they are factored into the cost of the financing transaction and, in any case, reduce the realization value of the encumbered assets. In addition, this approach involves formal procedures that are not geared to yield a reasonable market price for the encumbered assets.

21. In order to avoid these problems, some legal systems limit the role of courts or other authorities in the enforcement process. In these legal systems the secured creditor is often authorized to enforce its security right without any prior intervention of official State institutions, such as courts, bailiffs or the police. In other legal systems, there is only limited prior intervention of official State

institutions in the enforcement process.¹ The justification for such an approach lies in the fact that having the secured creditor or a trusted third party take control and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. It may also maximize the realization value of the encumbered assets.

22. However, even in these legal systems the courts are available to ensure recognition of legitimate claims and defences of the grantor and other parties with rights in the encumbered assets. In order to inform these parties and give them an opportunity to react, the secured creditor is required to give them a notice of default and enforcement (see paras. 14-15). In addition, if the debtor does not consent, the secured creditor may not enforce its rights if such enforcement would result in a disturbance of the public order (see para. 30). Moreover, in disposing of the encumbered assets, the secured creditor has to act in a “commercially reasonable” manner (see para. 33).

23. Even if permitted to act without official intervention, a secured creditor is normally not precluded from seeking to enforce its security right by judicial action. The secured creditor may choose to bring a judicial action, for example, to avoid the risk of having its private actions challenged after the fact or may conclude that it will have to bring a judicial action anyway to recover an anticipated deficiency.

24. Whether or not they require a secured creditor to resort to the courts, many legal systems modify the normal rules of civil procedure when a secured creditor seeks to enforce security rights. These modifications may limit the time within which the court must act or limit the claims or defences that the parties may raise. If the court concludes that there has been default, the objective of any decision should be to satisfy the creditor’s secured claim. The court should be authorized to order the debtor to pay the obligation, to dispose of the encumbered assets itself, or to turn over the assets to the secured creditor or to the court for disposition.

b. Freedom of parties to agree to the enforcement procedure

25. Another key issue for a secured transactions regime is the extent to which the secured creditor and grantor may agree to modify the statutory framework for the enforcement of the security right. Permitting the parties to agree freely on the consequences of their exchange encourages an efficient allocation of resources. When, however, a secured transactions law imposes mandatory obligations on a secured creditor, especially in those regimes that authorize enforcement with limited State intervention, the law may also prohibit or limit the parties’ ability to contract out of these obligations. The law may also distinguish between terms agreed to at the time the security agreement is concluded and terms agreed to after the debtor has defaulted.

¹ For example, under the Model Inter-American Law on Secured Transactions, the secured creditor has to file a notice of default and enforcement in the public register, and to deliver a copy to the debtor and any creditor with a publicized security right (see article 54). The secured creditor has to also apply to a court for an order of repossession which the court issues without a hearing (the debtor has to initiate an independent proceeding to challenge this order; see article 57). Once in possession of the asset, the secured creditor may sell it directly following certain prescribed procedures (see article 59).

c. Acceptance of the encumbered assets in satisfaction of the secured obligation

26. Following default the secured creditor may propose that it accept the encumbered assets in full or partial satisfaction of the secured obligation. Most jurisdictions make unenforceable an agreement that automatically vests ownership of the encumbered assets in the secured creditor upon default, if the agreement is set out in the security agreement, although some laws make a subsequent agreement enforceable. The advantage of permitting subsequent agreements is that enforcement costs are minimized and the security right is terminated more quickly. The disadvantage is that the secured party may put undue pressure on the debtor or grantor in cases where the encumbered assets are more valuable than the obligation secured.

27. The law may guard against abusive behaviour by requiring the consent of the debtor and grantor, third parties or the court under certain circumstances, such as where the debtor has made substantial payments on the secured debt. Publicity may be required and a fixed delay before final settlement may be prescribed to allow an appeal to a court. The law might also require an official appraisal.

d. Redemption of the encumbered assets

28. Most laws permit a defaulting debtor or grantor to redeem the encumbered assets by paying the outstanding secured obligation, including interest and the costs of enforcement up to the time of redemption. Redemption brings the transaction to an end. The hope of redemption may encourage the debtor or grantor to search for potential buyers to purchase the encumbered assets and to monitor the secured creditor's acts closely. Redemption of the encumbered assets should be distinguished from reinstatement of the secured obligation. Reinstating the secured obligation (e.g. by paying a missed instalment) cures a default and the restored obligation continues to be secured by the encumbered assets. Redeeming the encumbered assets discharges the secured obligation.

e. Authorized disposition by the grantor

29. Following default, the secured party will be concerned about realizing the maximum value of the encumbered assets. Frequently, the debtor will be more knowledgeable about the market for the assets than the secured creditor. For this reason, the debtor is often given a limited period of time following default during which it is entitled to dispose of the encumbered assets.

f. Removing the encumbered assets from the grantor's control

30. Upon the debtor's default, the secured creditor who is not already in possession of the encumbered assets will be concerned about potential dissipation or misuse of the assets. This may be alleviated by placing the assets in the hands of a court, a State official, a trusted third party or the secured creditor itself. Permitting the secured creditor to take possession without any or only limited recourse to a court or other authority reduces the costs of enforcement (see para. 21). However, even those laws that permit such repossession by the secured creditor recognize the potential for abuse, especially the possibility of public disorder or intimidation. Most of these laws, therefore, condition repossession on avoiding a disturbance of the public order ("breach of the peace"). Some require prior notice of default as a precondition to taking possession.

31. In the special case where the encumbered assets threaten to decline rapidly in value, most laws provide for preliminary relief ordered by a court or other relevant authority to preserve the value of the assets.

g. Sale or other disposition of the encumbered assets

32. A security right entitles the secured creditor to have the encumbered assets sold or otherwise disposed of. The objective of the disposition should be to maximize the value of the encumbered assets, while not jeopardizing the legitimate claims and defenses of the grantor or other persons.

33. Requirements in existing legal systems range from the less to the more formal. Some legal systems require disposition subject to the same public procedures used to enforce court judgements. Other legal systems permit the secured creditor to control the disposition but prescribe uniform procedures for the disposition by public auction of encumbered assets, with rules on such matters as timing, publicity and minimum price. Yet other legal systems permit the secured creditor to control the disposition subject to flexible rules on how to proceed. These systems may condition the right of the creditor on the consent of the grantor, whether in the security agreement or after default. A general standard is usually prescribed which the secured creditor must observe (e.g. “commercially reasonable” or “with the care of a prudent business person”). There may also be special rules for how the proceeds of a disposition are to be collected and kept pending distribution.

34. Most secured transactions laws share the requirement that notice must be given to certain parties with respect to a proposed disposition. Due to the finality of any disposition, detailed rules are necessary to alert interested parties to protect their interest. The issues regarding whom to notify, the manner of notification, and the timing of notification are similar to those discussed in connection with default (see paras. 14-15). Special procedures are often prescribed for the sale of a business as a going concern .

h. Allocation of proceeds of disposition

35. To minimize disputes, a secured transactions law should set out rules on the distribution of the proceeds of the disposition. The most common allocation is to pay reasonable enforcement costs first and then the secured obligation. The law should include rules on if and when a secured creditor is responsible for distributing proceeds to some or all other secured creditors with security rights in the same encumbered assets. These rules should require that notice of these other interests be given to the secured creditor. The law should also provide that any surplus proceeds are to be returned to the grantor.

36. The proceeds distributed to the secured creditor are applied towards satisfaction of the secured obligation. If there is a deficiency after the distribution, the obligation should be discharged only to the extent of the proceeds received. The law should provide expressly that the secured creditor is entitled to recover the amount of the deficiency from the debtor. Unless the debtor creates a security right in other assets for the benefit of the creditor, the creditor’s claim for the deficiency is unsecured.

i. Finality

37. A secured transactions law should provide finality following disposition of the encumbered assets. The secured creditor's security right in the encumbered assets should terminate, as should the grantor's rights. The law should also determine whether the rights of other persons in the encumbered assets (including other secured creditors) continue notwithstanding disposition of the assets in the enforcement procedure.

j. Variations on general framework

38. A secured transactions law that includes within its scope many different types of encumbered assets may need to provide, where necessary, special rules for the disposition of some types of asset. This is especially true of intangibles, securities and negotiable instruments. For example, a secured creditor with a security right in a receivable should be entitled to inform the obligor of the receivable following the debtor's default.

39. A secured transactions law should also address the issue of how a secured creditor is to proceed when a single transaction includes security rights in both movable and immovable assets. Enforcement of a security right in fixtures may also require special rules to deal with the problem of severing a fixture from immovable property owned by someone other than the grantor.

5. Judicial proceedings brought by other creditors

40. The secured transactions law should be coordinated with general civil procedural law to provide a right for secured creditors to intervene in court proceedings to protect security rights and to ensure consistent ranking of claims. The other creditors of the debtor or grantor may resort to the courts to enforce their claims against the debtor and procedural law may give these creditors the right to force the disposition of encumbered assets. The secured creditor will look to procedural law for rules on intervening in these judicial actions in order to protect its priority. In some cases, procedural law may provide exceptions to general rules of priority. In some legal systems, for example, a court may order a person who owes money to a judgement debtor to pay the judgement creditor. If a secured creditor has a security right in this receivable, the court order may effectively give priority to the judgement creditor. If this reversal of the general rules of priority is unintended, the relevant law should be corrected.

B. Summary and recommendations

41. The key objectives of provisions on default and enforcement in a secured transactions regime are to:

- (i) Provide clear, simple and transparent rules for the enforcement of security rights following a debtor's default, and for the post-default rights, obligations, and priorities of interested parties;
- (ii) Maximize the realization value of the encumbered assets in a manner consistent with protection of the rights of interested parties and the public;

-
- (iii) Provide transactional finality upon compliance with the enforcement procedure;
 - (iv) Clearly define the extent to which the secured creditor and the debtor may agree on the procedure for realization of the value of the encumbered assets; and
 - (v) Coordinate the enforcement rights and procedures of the security right regime with the rights and procedures for security rights in insolvency proceedings.

42. The law need not define “default”. If a definition is included, it is sufficient to state that a default occurs when the debtor fails to perform a secured obligation or is otherwise in default, as defined by the security agreement or other law. The law should address the question whether notice of default should be given and to whom. The debtor should have recourse to the courts or other relevant authorities to challenge a creditor’s claim of a default, or the calculation of the amount owing as a result of the default. To avoid unduly delaying rightful enforcement, the review should be expedited. Safeguards should be built into the process to discourage debtors from making unfounded claims to delay the enforcement.

43. *[Note to the Working Group: The Working Group may wish to consider the extent of judicial control of the enforcement process. The Working Group may wish to consider in particular (see paras.19-25 and 30-34):*

- (i) whether, in the case of a non-possessory security interest, some type of official intervention should be required for the repossession of the encumbered asset by the secured creditor or whether the secured creditor should be authorized to remove the encumbered asset from the debtor’s control, subject to provisions relating to public order; and*
- (ii) whether, subject to reasonable commercial standards and provisions guarding against abusive behaviour, the secured creditor should be authorized to dispose of the asset directly or through a court supervised procedure.]*

44. Following default, the debtor or grantor should be permitted to redeem the encumbered assets by paying the outstanding secured obligation, including interest and the costs of enforcement up to the time of redemption.

45. The law should set out rules on the distribution of the proceeds of the disposition. Proceeds should be allocated in the following order: reasonable costs of disposition; the secured obligation; other secured obligations; and the surplus, if any, to the grantor. If application of the proceeds to the secured obligation leaves a deficiency, the secured creditor should be entitled to an unsecured claim for the deficiency against the debtor. Following disposition of the encumbered assets, there should be finality.

46. Special rules for the disposition of intangibles, negotiable instruments and fixtures should be considered. The law should also provide guidance on applicable procedures when a single transaction includes security rights in both movables and immovables.

47. There is a need for coordination with general civil procedural law to provide for intervention in court proceedings to protect security rights and to ensure consistent ranking of claims.

General AssemblyDistr.: Limited
18 April 2002*

Original: English

**United Nations Commission
on International Trade Law**Working Group VI (Security Interests)
First session
New York, 20-24 May 2002**Security Interests****Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-37	2
X. Insolvency	1-37	2
A. General remarks	1-30	2
1. Introduction	1-6	2
a. Scope and commercial context	1-5	2
b. Terminology	6	3
2. Key objectives	7-10	4
3. Security rights in insolvency proceedings	11-30	4
a. The inclusion of encumbered assets in the insolvency estate	11-15	4
b. Limitations on the enforcement of security rights	16-21	5
c. Participation of secured creditors in insolvency proceedings	22-23	6
d. The validity of security rights and avoidance actions	24	7
e. The relative priority of security rights	25-27	7
f. Security rights in reorganization proceedings	28-30	8
B. Summary and recommendations	31-37	9

* This addendum is submitted five weeks less than the required ten weeks prior to the start of the meeting because the secretariat of the Commission was fully occupied with the preparation of other documents, including another eleven addenda of A/CN.9/WG.VI/WP.2.

X. Insolvency

A. General remarks

1. Introduction

a. Scope and commercial context

1. This Chapter examines the effects of insolvency proceedings on the enforcement rights of the secured creditor. It should be read together with the UNCITRAL Legislative Guide on Insolvency Law, which addresses the issues identified here in the broader context of insolvency law (see A/CN.9/WG.V/WP.57, A/CN.9/WG.V/WP.58 and A/CN.9/WG.V/WP.61).

2. While a legal system may have distinct regimes for secured transactions and insolvency, both regimes are concerned with debtor-creditor relations, and both encourage credit discipline on the part of debtors. Effective regulation in either area will contribute to positive outcomes in the other. A secured transactions law, for example, may expand the availability of credit, thus facilitating the operation of a business and the avoidance of insolvency. A secured transactions law may also promote responsible behaviour on the part of the creditors to the extent it requires creditors to monitor the ability of debtors to perform their obligations, thereby discouraging over-indebtedness and consequent insolvency.

3. Nevertheless, there are tensions where secured transactions and insolvency law intersect, resulting from the different approaches taken to debt. A secured transactions regime seeks to ensure that certain obligations are met, while an insolvency regime deals with circumstances where obligations cannot be met. In addition, the former regime focuses on effective enforcement rights of individual creditors to maximize the likelihood that the obligations owed are performed. The latter regime, on the other hand, seeks to maximize the return to all creditors by preventing a race between creditors to dismember the assets of their common debtor. These results need to be considered by legislators, reform in one regime can have a wider regulatory effect, imposing unforeseen transaction and compliance costs on stakeholders of the other regime. For this reason, conflicts between the rights and obligations, imposed by the different regimes governing secured transactions and insolvency, should be identified by a country in its law reform process.

4. Insolvency regimes generally contain two main types of proceedings: liquidation (which involves the termination of the commercial business of the debtor, and the subsequent realisation and distribution of the insolvency debtor's assets), and reorganization (designed to maximize the value of assets, and returns to creditors, by saving a business rather than terminating it). In a liquidation proceeding, the insolvency representative is entrusted with the task of gathering the insolvency debtor's assets, selling or otherwise disposing of them, and distributing the proceeds to the debtor's creditors. To maximize the liquidation value of these assets, the representative may continue the debtor's business for a short time and may sell the business as a going concern rather than selling individual assets separately. In a reorganization proceeding, on the other hand, the assumption is that the insolvency debtor's business will continue as a going concern. Thus, the goal of the proceedings is to maximize the value of the debtor's business by allowing the debtor to overcome its financial difficulties and resume or continue normal commercial operations.

5. In addition to legislative forms of insolvency proceeding, alternative approaches are evolving (e.g. out-of-court settlements by the creditors of an insolvent debtor). These processes respond to the need to support economic stability by rapid adjustment of the claims of financial institutions, when it is uncertain whether the relevant insolvency institutions can act quickly and effectively.

[Note to the Working Group: The Working Group may wish to take into account in its deliberations that Working Group V (Insolvency Law) is considering these alternative approaches (see A/CN.9/507 and A/CN.9/WG.V/WP.61/Add.1).]

b. Terminology

[Note to the Working Group: The Working Group may wish to consider whether these definitions should be moved to Chapter I (see A/CN.9/WG.VI/WP.2/Add.1).]

6. This Chapter uses the following terms in the sense indicated:

Insolvent debtor	An “insolvent debtor” is a person [or entity] engaged in a business and which meets the criteria for, and is subject to, insolvency proceedings; an insolvent debtor may be either the “debtor” or the “grantor” as those terms are used in this Guide.
Insolvency proceedings	“Insolvency proceedings” are collective proceedings which involve the [partial or total] divestment of the insolvent debtor and the appointment of an insolvency representative [for the purpose of either liquidation or reorganization of the business] [including both liquidation and reorganization proceedings].
Insolvency representative	An “insolvency representative” is a person [or entity] appointed by the court which is in charge of administering the debtor’s estate [and assisting and watching over the management of the business] with a view to either liquidation or reorganization of the business.
Secured claim	A “secured claim” is a claim made in an insolvency proceeding, secured by a security right.

2. Key objectives

[Note to the Working Group: The Working Group may wish to consider whether the discussion of these key objectives should be included in Chapter I (see A/CN.9/WG.VI/WP.2/Add.1).]

7. Legislation addressing the rights of a secured creditor when insolvency proceedings have been commenced against its debtor or grantor should be aimed at facilitating enforcement, establishing clear priority rules and recognizing party autonomy (see A/CN.9/WG.VI/WP.2/Add.1, sections D, E and G).

8. If a security right is valid outside insolvency proceedings so that it is effective not only against the debtor but also against third parties, the validity of the security right should be recognized in the insolvency proceeding. Similarly, if a security right has priority over the claim of another creditor outside the insolvency proceeding, the commencement of an insolvency proceeding should not alter the relative priority of these claims. Any exceptions should be limited to the extent possible and be clear and transparent to allow potential financiers to estimate the risk of non-payment and thus the cost involved in a transaction (see also objective 7 in A/CN.9/WG.V/WP.57, para. 21).

9. The secured transactions and insolvency regimes should be co-ordinated in regulating the enforcement of security rights. As already noted (see A/CN.9/WG.VI/WP.2/Add. 9, para. 4), the secured creditor will take into account any limitation of its rights in an insolvency proceeding when assessing whether to advance credit to a debtor and at what cost. In addition, other creditors will have an incentive to commence insolvency proceedings when the debtor is in financial difficulty so as to limit the secured creditor's rights and increase the likelihood of their claims against the debtor being successful.

10. Most legal systems recognize party autonomy in private agreements. There may, however, be public policy reasons for restricting a secured creditor's ability to enforce a security right in some circumstances when insolvency proceedings have been commenced against the debtor. In such cases, certainty is needed. The more predictable these limitations are, and the more the economic value of the security right is preserved, the less adverse will be the impact on the credit enhancement otherwise provided by the use of security rights.

3. Security rights in insolvency proceedings

a. The inclusion of encumbered assets in the insolvency estate

11. An initial question is whether the secured creditor's security right is subject to insolvency proceedings or, in other words, whether the encumbered assets are part of the "estate" created when insolvency proceedings are commenced against a debtor (see A/CN.9/WG.V/WP.58, paras. 46-47). The estate is comprised of those assets of an insolvent debtor that are made subject to administration in the insolvency proceedings.

12. Inclusion of encumbered assets within the insolvency estate can give rise to different effects. In many jurisdictions, this will limit a secured creditor's ability to enforce its security right (see para. 16). Any such legislative limitations on commercial agreements will be taken into account by creditors when deciding whether to extend credit to a debtor, and at what cost. Some insolvency laws that

require all assets to be subject to insolvency proceedings in the first instance allow the separation of encumbered assets from the estate where there is proof of harm or prejudice to the secured creditor's right.

13. To allow for an assessment of whether the continuation of the proceedings will maximize the eventual return to creditors overall, an insolvency law may subject the encumbered assets to control within the insolvency proceedings. As a consequence, a secured creditor may be required to surrender possession of the encumbered assets to the insolvency representative. This approach may be taken not only in reorganization proceedings, but also in liquidation proceedings in which the insolvent debtor's business is to continue while assets are liquidated in stages, or there is a likelihood that the business may be sold as a going concern. As it may not be possible to know at the commencement of insolvency proceedings whether it is desirable to continue the business, many insolvency regimes include the encumbered assets in the estate for a limited time period.

14. An insolvency estate will normally include all assets in which the insolvent debtor has a right at the time insolvency proceedings are commenced. In some jurisdictions, assets in which a creditor retains legal title or ownership may be separated from the insolvency estate. Examples include a retention of title by the secured creditor, a financial lease or a transfer of title to the secured party (see Chapter III.A.3). In other jurisdictions in which these types of legal devices are assimilated with other forms of secured credit arrangements into a general category of "security right", title-based and other security rights are treated in the same way even in insolvency proceedings. This issue is an example of where it may be necessary to co-ordinate the approaches taken in the secured transaction and insolvency regimes.

15. Some secured creditors will participate in insolvency proceedings because they have both a secured and an unsecured claim. This is not limited to situations where the creditor has two separate obligations, only one of which is secured. It also occurs when the secured creditor is under-secured (i.e. the value of the encumbered assets is less than the amount of the secured obligation). In such a case, the secured creditor has a secured claim only to the extent of the value of the encumbered assets and an unsecured claim for the difference (see also section A.3.b).

b. Limitations on the enforcement of security rights

16. Many insolvency laws limit the rights of creditors to pursue any remedies or proceedings against the debtor after insolvency proceedings are commenced, through the imposition of a stay or moratorium. The stay may be imposed either automatically, or by court order. A number of jurisdictions extend the stay to both unsecured and secured creditors. The same reasons for including encumbered assets within the estate apply to the stay of enforcement of security rights. Limitations, however, on a secured creditor's ability to enforce its security right may have an adverse impact on the cost and availability of credit. An insolvency law must balance these competing interests (see A/CN.9/WG.V/WP.58, paras. 69-82).

17. With few exceptions (see para. 13), the need to stay enforcement of a security right is less compelling when the insolvency proceeding is a liquidation proceeding. In most liquidation proceedings, the insolvency representative will dispose of assets individually rather than by selling the business as a going concern. Different approaches may be taken to account for this. For example, an insolvency regime

may exclude secured creditors from the application of the stay, but encourage negotiations between the insolvent debtor and the creditors prior to commencement of the insolvency proceedings to achieve the best outcome for all parties. An alternative approach would provide that the stay lapses after a brief prescribed period of time (e.g. 30 days) unless a court order is obtained, extending the stay on grounds specified in the insolvency law. These grounds might include a demonstration that there is a reasonable possibility the business will be sold as a going concern; this sale will maximize the value of the business; and secured creditors will not suffer unreasonable harm.

18. A stronger case for a stay is made when the insolvency proceeding is a reorganization proceeding. The objective of such a proceeding is to restructure a potentially economically viable entity so as to restore the financial well being and viability of the business, and to maximize the return to creditors. This may involve restructuring the finances of the business by such means as debt forgiveness, debt rescheduling, debt-equity conversions, and sale of all or part of the business as a going concern. Removal of encumbered assets from the business will often defeat attempts to continue the business and sell it as a going concern. Accordingly, an insolvency law might extend the application of a stay to secured creditors for the time period necessary to formulate and present a reorganization plan to creditors.

19. If an enforcement action by a secured creditor is stayed, an insolvency regime should provide safeguards to protect the economic value of the security rights. Such safeguards might include court orders for cash payments for interest on the secured claim, payments to compensate for the depreciation of the encumbered assets and extension of the security right to cover additional or substitute assets.

20. In addition, an insolvency law might also relieve a secured creditor from the burden of a stay by authorizing the insolvency representative to release the encumbered assets to the secured creditor. Grounds for such a release might include cases where the encumbered assets are of no value to the estate and are not essential for the sale of the business, cases where it is not feasible or is overly burdensome to protect the value of the security right.

21. Where the value of the encumbered assets is greater than the secured claim, the insolvency estate has an interest in the surplus. In the absence of insolvency, the secured creditor would have to account to the grantor for the surplus proceeds. If the same assets are disposed of during insolvency proceedings, the surplus would be available for distribution to other creditors. As to who should dispose of the encumbered assets, an insolvency law should address the question whether the same policies that apply outside of insolvency should apply also in insolvency proceedings. For example, if the secured transactions law authorizes the secured creditor to dispose of an asset outside insolvency, the question is whether the secured creditor, rather than the insolvency representative, should control disposition of the relevant encumbered assets during insolvency.

c. Participation of secured creditors in insolvency proceedings

22. If secured creditors are required to participate in insolvency proceedings, the insolvency regime should ensure that participation is effective to protect the interests of secured creditors (see A/CN.9/WG.V/WP.58, paras. 199-203). For example, the notification to creditors announcing the commencement of insolvency

proceedings should indicate whether secured creditors need to make a claim and, if so, to what extent.¹

23. In addition, if an insolvency law provides for creditor committees to advise the insolvency representative, the law should provide for adequate representation of the interests of secured creditors. Secured creditor representatives may sit on a committee with representatives of unsecured creditors or, alternatively, the law might provide for a separate committee for secured creditors. Concerns that the interests of secured creditors might dominate proceedings to the detriment of other creditors, might be addressed by limiting the issues on which secured creditors may vote. For example, voting might be restricted to the selection of the insolvency representative and matters directly affecting encumbered assets or the economic value of security rights.

d. The validity of security rights and avoidance actions

24. In general, a security right valid outside of insolvency should be recognized as valid in an insolvency proceeding. However, a challenge to the validity of a security interest in insolvency proceedings should be on the same grounds that any other claim might be challenged. Many jurisdictions allow an insolvency representative, for example, to set aside (“avoid”) or otherwise render ineffective any fraudulent or preferential transfer made by the insolvency debtor within a certain period before the commencement of insolvency proceedings. The granting or transfer of a security interest is a transfer of property subject to these general provisions, and if that transfer is fraudulent or preferential, the insolvency representative should be entitled to avoid or otherwise render ineffective the security right. This would mean that a security right, which is valid under the secured transaction regime of a jurisdiction, may be invalidated, in certain circumstances, under the insolvency regime of the same jurisdiction (see A/CN.9/WG.V/WP.58, paras. 124-151).

e. The relative priority of security rights

25. A secured transaction regime will establish the priority of claims to encumbered assets (see Chapter VII). Insolvency laws may affect that priority (see A/CN.9/WG.V/WP.58, paras. 217-233). Many laws, for example, give a priority to claims for unpaid wages and employee benefits, environmental damage and Government taxes (“privileged claims”). While most legal systems award these claims priority only over unsecured claims, some regimes extend the priority to rank ahead of even secured claims. It is desirable, however, that these types of exceptions to the first priority of secured creditors be limited as the greater the uncertainty regarding the number and amounts of such claims, the greater will be the negative impact on the availability and cost of credit.

[Note to the Working Group: The preceding paragraph focuses on the relative priority of secured and preferential creditors. Where insolvency laws do alter the pre-insolvency ranking of secured and unsecured creditors upon insolvency, unsecured creditors may have an incentive to commence insolvency proceedings. While this should be balanced against the corresponding incentive on secured creditors to monitor debtors, there will be a need for safeguards, in such regimes, to prevent abuse of the insolvency regime as a debt collection method by unsecured

¹ For notification to foreign creditors, see article 14 of the UNCITRAL Model Law on Cross-Border Insolvency and paras. 106-111 of the Guide to Enactment of the Model Law.

creditors. The draft Legislative Guide on Insolvency Law does not recommend any alteration of the relative priority of secured creditors as against unsecured creditors. The Working Group may wish to consider whether to include discussion on this point in the draft Legislative Guide on Secured Transactions.]

26. The insolvency representative may incur costs in the maintenance of encumbered assets and pay for these costs from the general funds of the insolvency estate. Because such expenditure preserves the economic value of the security right, not to grant priority over the secured creditor for these administrative expenses would unjustly enrich the secured creditor to the detriment of the unsecured creditors. To discourage unreasonable expenditure, however, an insolvency law might limit the priority to the reasonable cost of foreseeable expenses.

27. An insolvency representative may be authorized to grant creditors that extend credit to the insolvency estate a security right in assets already encumbered by a security right created before commencement of the insolvency proceedings. The question arises here whether post-commencement secured creditors should be able to obtain priority over the rights of existing secured creditors. In legal systems where this type of priority is recognized, it is rarely given without the consent of the secured creditors that would be subordinated (see A/CN.9/WG.V/WP.58, paras. 187-190).

[Note to the Working Group: The Working Group may wish to consider elaborating in greater detail on the priority of post-commencement financing, including the minimum conditions that may be acceptable for granting a post-commencement secured creditor priority over an existing secured creditor.]

f. Reorganization plans

28. The principal objective of reorganization proceedings is to maximize the value of the debtor's business (and the return to creditors) by formulating a plan for its rescue (see A/CN.9/WG.V/WP.58, paras. 261-286). A stay of proceedings during the formulation of a plan may postpone the exercise of the rights of secured creditors but need not affect their substantive secured rights. Once the plan has been formulated, however, the question arises as to who must approve the plan before it becomes effective (on the approval of the plan by secured creditors, see A/CN.9/WG.V/WP.58, paras. 276-277). Another question is who might be bound by the plan. If secured creditors are not bound by the plan and are entitled ultimately to the full economic value of their security rights, approval by the secured creditors would not be necessary because their rights would not be impaired.

29. However, as reorganization may only be feasible if the secured creditors receive less than the full value of their secured claims, most insolvency regimes require creditors to approve a plan by a certain majority in number and amount of the claims. Some jurisdictions permit secured creditors to vote as a class on a plan that proposes to impair their claims. Although a vote by the class to approve the plan binds the dissenting secured creditors, these regimes usually require that the dissenters receive at least as much as they would receive in a liquidation proceeding.

30. In most insolvency regimes, a court must confirm a proposed reorganization plan. In such jurisdictions, the insolvency law may set out grounds on which a court may reject the plan. These grounds include the likelihood that the proposed plan may not be feasible because secured creditors are not bound by the plan and may

remove essential encumbered assets from the business subject to the plan. In these circumstances, some regimes provide that the court may bind secured creditors to the plan if certain conditions are satisfied. These conditions include ordering measures to provide adequate protection of the economic value of the security right.

[Note to the Working Group: The Working Group may wish to consider the treatment of security rights in the case out-of-court restructuring taking into account the relevant discussion by Working Group V (Insolvency Law) (see A/CN.9/507, para. 244 and A/CN.9/WG.V/WP.61/Add.1).]

B. Summary and recommendations

31. A secured transactions regime should establish clear priority rules, facilitate enforcement and recognize party autonomy. Any exceptions should be limited, clear and transparent.

32. In principle, encumbered assets should be included in the insolvency estate. Whether assets that are subject to a retention or transfer of title arrangement (see Chapter III.A.3.) should form part of the estate or not depends on whether such quasi-security devices are assimilated into a general category of security rights or not.

[Note to the Working Group: The Working Group may wish to consider whether transfer or retention of title arrangements should be assimilated into a general category of security rights.]

33. If secured creditors are required to participate in insolvency proceedings, the insolvency regime should ensure that participation is sufficiently effective to protect the interests of secured creditors.

34. The distinction between insolvency proceedings designed to liquidate the assets of an insolvency debtor and proceedings designed to rescue the business of the insolvency debtor support different treatment of security rights in those proceedings.

35. With few exceptions (see para. 13), the need to stay enforcement of a security right is less compelling when the insolvency proceeding is a liquidation proceeding than when it is a reorganization proceeding. Application of the stay, its duration, and the grounds for relief from the stay should be adjusted accordingly. In any event, the secured creditors should be provided with safeguards to ensure adequate protection of the economic value of their security rights when their right to enforce their security rights is deferred by the stay.

[Note to the Working Group: The Working Group may wish to consider whether the same policies for determining who should dispose of the encumbered assets outside of insolvency should generally apply in insolvency proceedings.]

36. Subject to any avoidance actions, security rights created before the commencement of an insolvency proceeding should be equally valid in an insolvency proceeding.

37. As a general rule, insolvency proceedings should not alter the priority of secured claims prevailing before the commencement of the insolvency proceedings. Certainty and transparency with respect to any necessary exceptions will help limit the negative impact on the availability and cost of credit.

[Note to the Working Group: The Working Group may wish to consider whether post-commencement financing secured by security rights in already encumbered assets should be given priority over secured creditors with existing security rights in the same assets and if, so, under what conditions.]

General AssemblyDistr.: Limited
4 April 2002

Original: English

**United Nations Commission
on International Trade Law**Working Group VI (Security Interests)
First session
New York, 20-24 May 2002**Security Interests****Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum*****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-25	2
XI. Conflict of laws and territorial application	1-25	2
A. General remarks	1-24	2
1. Introduction	1-7	2
a. Purpose of conflict-of-laws rules	1-4	2
b. Scope of conflict-of-laws rules	5-7	3
2. Conflict-of-laws rules for creation, publicity and priority	8-14	4
3. Effect of a subsequent change in the connecting factor	15-18	5
4. Conflict-of-laws rules for enforcement issues	19-24	6
B. Summary and recommendations	25	7

* This addendum is submitted three weeks less than the required ten weeks prior to the start of the meeting because the secretariat of the Commission was fully occupied with the preparation of other documents, including another eleven addenda of A/CN.9/WG.VI/WP.2, nine of which have already been submitted.

XI. Conflict of laws and territorial application

A. General remarks

1. Introduction

a. Purpose of this chapter

1. This Chapter discusses the rules for determining the law applicable to the creation, publicity, priority and enforcement of a security right. These rules are generally referred to as conflict-of-laws rules and also determine the territorial scope of the substantive rules envisaged in the Guide. For example, if a State has enacted the substantive rules envisaged in the Guide relating to the priority of a security right, these rules will apply to a priority contest arising in the enacting State only to the extent that the conflict-of-laws rule on priority issues points to the laws of that State. Should the conflict rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State, and not pursuant to the substantive priority rules of the enacting State.

2. After a security right has become effective, a change might occur in the connecting factor for the choice of the applicable law. For instance, if security over tangible goods located in State A is governed by the law of the location of the goods, the question arises as to what happens if goods subject to a security right in that State are subsequently moved to State B (whose conflict rules also provide that the location of the goods governs security rights over tangible property). One alternative would be for the security to continue to be effective in State B without the need to take any further step in State B. Another alternative would be for new security to be obtained under the laws of State B. Yet another alternative 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 (e.g. 30 days after the goods have been brought into State B). These issues are addressed by the conflict-of-law rules of some legal systems. This Chapter proposes a general rule in this regard.

3. Conflict-of-laws rules should reflect the objectives of an efficient secured transactions regime. Applied to the present Chapter, this means that the law applicable to the property aspects of a security right should be capable of easy determination: certainty is a key objective in the elaboration of rules affecting secured transactions both at the substantive and conflict-of-laws levels. Another objective is predictability. As illustrated by the questions in the preceding paragraph, the conflict-of-laws rules should permit the preservation of a security right acquired under the laws of State A if a subsequent change in the connecting factor for the selection of the applicable law results in the security right becoming subject to the laws of State B. A third key objective of a good conflict-of-laws system is that the relevant rules must reflect the reasonable expectations of interested parties (creditor, debtor and third parties). According to many, in order to achieve this result, the law applicable to a security right should have some connection to the factual situation that will be governed by such law.

4. Use of the Guide (including this Chapter) in developing secured transactions laws will help reduce the risks and costs resulting from differences between current conflict-of-laws rules. 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 the insolvency of the debtor). If those States have different conflict-of-laws rules in relation to the same type of encumbered assets, the creditor will need to comply with more than one regime in order to be fully protected. A benefit of different States having harmonized conflict-of-laws rules is that a creditor can rely on one single law to determine the priority status of its security in all such States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention.

[Note to the Working Group: Reference could be made in this context to the convention being prepared by the Hague Conference on Private International Law on the law applicable to dispositions of indirectly held securities, once that text is finalized].

b. Scope of the conflict-of-laws rules

5. This Chapter does not define the security rights to which the conflict-of-laws rules will apply. Normally, the characterization of a security right for conflict-of-laws purposes will reflect the substantive security rights law in a jurisdiction. The question arises, however, as to whether the conflict-of-laws rules for security rights should also apply to other transactions that are functionally similar to security, even if they are not covered by a secured transactions regime. To the extent that title reservation agreements, financial leases, consignments and other similar transactions would not be governed by the substantive law rules, a State might nonetheless subject them to the conflict-of-laws rules applicable to secured transactions.

6. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation, publicity and priority be the same as for a security right over the same category of property. An example is found in the United Nations Assignment Convention, which (including its conflict-of-laws rules) applies to outright transfers of receivables as well as to security rights over receivables. This policy choice is motivated, *inter alia*, by the necessity of referring to one single law to determine priority between competing claimants to the same receivable. In the event of a priority dispute between a purchaser of a receivable and a creditor holding security over 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 laws of State A but the priority of the secured creditor were governed by the laws of State B.

7. Whatever decision a jurisdiction makes on the range of transactions covered by the conflict-of-laws rules, the scope of the rules will be confined to the property aspects of these transactions, which are matters that are outside the domain of freedom of contract. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the creation of a property right. The rule would not apply to the personal obligations of the parties under their contract.

2. Conflict-of-laws rules for creation, publicity and priority

8. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis:

- (i) the first issue is whether the security has been validly created (see Chapter IV);
- (ii) the second issue is whether the security is effective against third parties (see Chapters V and VI); and
- (iii) the third issue is what is the priority ranking of the secured creditor (see Chapter VII).

9. Legal systems do not all make specific conceptual distinctions between these issues. In some legal systems, the fact that a property right has been validly created necessarily implies that the right is effective against third parties. Moreover, legal systems that clearly distinguish between the three issues do not always establish separate substantive rules on each issue. For example, in the case of a possessory pledge complying with the requirements for the *in rem* validity of a security right results in the security being effective against third parties without any need for further action.

10. The key question is whether one single conflict-of-laws rule should apply to all three issues. The alternative is to allow for more flexibility, where it may be more appropriate that the law applicable to publicity or priority be different from that governing the creation of the right. Policy considerations, such as simplicity and certainty, favour adopting one rule for creation, publicity and priority. As noted above, the distinction between these issues is not always made or understood in the same manner in all legal systems, 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 non-consensual security.

11. Another important question is, whether on any given issue (i.e. creation, publicity or priority) the relevant conflict-of-laws rule should be the same for tangible and intangible property. A positive answer to that question would favour a rule based on the law of the location of the grantor. The alternative would be the place where the encumbered asset is held (*ex situs*), which would, however, be inconsistent in respect of receivables with the United Nations Assignment Convention.

12. Simplicity and certainty considerations support the adoption of the same conflict-of-laws rule for both tangible and intangible property, especially if the same law applies to creation, publicity and priority. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a debtor. 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 over the same property governed by the law of State B).

13. Not all jurisdictions, however, regard the law of the location of the grantor as sufficiently connected to security rights over tangible property (for “non-mobile” goods at least). Moreover, the law governing security would need to be same as the law governing a sale of the same assets. This means that acceptance of the grantor’s law for every type of security would be workable only if jurisdictions, generally, were prepared to accept that rule for all transfers.

14. In addition, it is almost universally accepted that a possessory right should be governed by the law of the place where the property is held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated 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.

[Note to the Working Group: If the scope of the law envisaged by this Guide is limited to commercial goods, equipment and trade receivables, it may be unnecessary to decide whether there should be special conflict-of-laws rules for certain categories of intangible property, such as non-trade receivables, securities, bank deposits, letters of credit and intellectual property. The issue should, however, be considered, as assets within these categories of property often comprise a significant part of the value of an enterprise. In particular, the absence of a conflict-of-laws rule for intellectual property could cause great difficulties in commercial transactions.

In another vein, to the extent that the conflict-of-laws rules of this Guide might overlap in some respects with the rules proposed by other international organizations (e.g. the Hague Conference, in the area of indirectly held securities), the Working Group may wish to consider ways to ensure coherence and to avoid inconsistencies].

3. Effect of subsequent change in the connecting factor

15. Whatever connecting factor is retained for determining the most appropriate conflict-of-laws rule for any given issue, there might occur a change in the relevant factor after the security has been created. For example, where the applicable law is that of the jurisdiction where the grantor has its head office, the grantor might later relocate its head office to another jurisdiction. Similarly, where the applicable law would be the law of the jurisdiction where the secured property was located, the property might be moved to another jurisdiction.

16. If these issues are not dealt with specifically, an implicit rule might be drawn. The general conflict-of-laws rules on creation, publicity and priority 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 issues that arose before the change (e.g. creation), while the subsequent governing law would apply to events occurring thereafter (e.g. a priority issue between two competing claimants).

17. The 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 in the event of a priority dispute occurring after the change (on the basis that third parties dealing with the debtor are entitled to determine the applicable law for all issues relying on the actual connecting factor, being the connecting factor in effect at the time of their dealings).

18. Providing a rule on these issues would appear to be necessary to avoid uncertainty, in particular where the connecting factor changes from a State that has not enacted the law envisaged by this Guide to an enacting State.

4. Conflict-of-laws rules for enforcement issues

19. Where a security right is created and publicized under the law of one State, but is sought to be enforced in another State, an issue arises regarding what remedies are 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 could allow enforcement by the secured creditor without prior recourse to the judicial system unless there is a breach of peace (“self-help”), while the law of the place of enforcement might require judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

20. One option is to subject enforcement remedies to the law of the place of enforcement, i.e. the law of the forum (*lex fori*). The policy reasons in favour this rule include:

- (i) the law of remedies would coincide with the law generally applicable to procedural issues;
- (ii) the law of remedies would, in many instances, coincide with the *situs* of the property being the object of the enforcement (and could also coincide with the law governing priority if the conflict-of-laws rules of the relevant state point to the *situs* for priority issues);
- (iii) the requirements would be the same for all creditors intending to exercise rights against the assets of a debtor, irrespective of whether such rights are domestic or foreign in origin.

21. On the other hand, the *lex fori* might not give effect to the intention 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 security was created. For example, if self-help is permitted under the law governing the creation of the security, self-help would also be available to the secured creditor in the State where the latter has to enforce its security, even if self-help is not generally allowed under the domestic law of that State.

22. An approach based on the reasonable expectations of the parties would mean a rule referring enforcement issues to the law governing the creation of the security right. This solution would also avoid separating the remedies from the nature of the rights conferred by a security. Such a separation is not evident where the remedies are closely linked to the attributes of the security (for instance, the remedies of a

conditional seller may be viewed as stemming from the fact that it has remained the legal owner of the goods). To the extent that the conflict-of-laws rule on priority issues would be the same as for creation and publicity, another benefit of the law regarding creation of the security and the law governing enforcement coming from the same regime would be that priority and enforcement issues would be subject to the same law.

23. A third option is to adopt a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This would often correspond to their expectations and, in many instances, would also coincide with the law applicable to the creation of the security right since that law is often selected as also being the law of the contract. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum or the law governing creation, publicity and (or) priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the property of their common debtor.

24. 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, or of the law governing validity and publicity. Procedural matters would, in any case, need to be governed by the law of the forum. As a result, the various enforcement issues would be treated differently.

[Note to Working Group: Consideration might also be given to the impact of insolvency on any conflict-of laws rule for enforcement measures, and whether this Guide should deal with this issue or whether it is more appropriately dealt with in the Guide on Insolvency.]

B. Summary and recommendations

[Note to Working Group: As to the law applicable to the creation, publicity and priority of security rights, the Working Group may wish to consider the following alternatives:

Alternative 1

General rule: The creation, publicity and priority of a security right over tangible and intangible property are governed by the law of the location of the grantor (the location of the grantor would have to be defined; see, for example, article 5(h) of the United Nations Assignment Convention which locates a commercial grantor in the State in which it has its place of central administration).

Exceptions: The law of the location of the property governs the creation, publicity and priority of a possessory security right, and the priority of a non-possessory security right over tangible property, money, negotiable documents and instruments (other classes of intangible property capable of being subject to a possessory pledge may have to be added).

Alternative 2

General rule: The creation, publicity and priority of a security right are governed by the law of the location of the property.

Exceptions: The law of the location of the grantor governs the creation, publicity and priority of a non-possessory security right over intangible property, and of any security right over tangible property of a type that is normally used in more than one jurisdiction. A sub-alternative would be to subject mobile goods to the law of the place where their movements are controlled.

Consideration might be given to providing for an additional rule for goods in transit. A security right over such goods may be validly created and publicized under the law of the place of destination provided that they are moved to that place within a certain time limit.

The above rules do not specifically refer to proceeds, on the assumption that the conflict-of law rules for proceeds should, in principle, be the same as those applicable to a security right initially obtained over the same type of property.]

25. A security right validly created and publicized under the law of a State other than a State that has enacted the legislation envisaged in this Guide continues to be valid and publicized in an enacting State after the connecting factor changes to the enacting State, if the publicity requirements of the enacting State are complied with within a specified grace period. This rule would imply that creation issues continue to be governed by the initial governing law while publicity (and priority to the extent that priority is governed by the same law as publicity) would be governed, after the change, by the law of the enacting State.

[Note to Working Group: With regard to the law applicable to enforcement issues, the Working Group may wish to consider the following alternatives:

Alternative 1

Substantive matters affecting the enforcement of the rights of a secured creditor are governed by the law of the State where enforcement takes place (i.e. by the law of the forum).

Alternative 2

Substantive matters affecting the enforcement of the right of a secured creditor are governed by the law governing the creation [and the priority] of the security right.

Alternative 3

Substantive matters affecting the enforcement of the rights of a secured creditor are governed by the law governing the contractual relationship of the creditor and the debtor, with the exception of [...].]

General AssemblyDistr.: Limited
15 March 2002

Original: English

**United Nations Commission
on International Trade Law**Working Group VI (Security Interests)
First session
New York, 20-24 May 2002**Security Interests****Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum*****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Draft legislative guide on secured transactions	1-11	2
XII. Transition issues	1-11	2
A. General remarks	1-10	2
1. General rule as to pre-effective date transactions	1-4	2
2. Exceptions to the general rule	5-10	2
a. Disputes before a court or arbitral tribunal	5	2
b. Effectiveness of pre-effective date rights as between the parties	6	3
c. Effectiveness of pre-effective date rights as against third parties	7-8	3
d. Priority disputes	9-10	3
B. Summary and recommendations	11	4

* This addendum is submitted four days less than the required ten weeks prior to the start of the meeting because ITLB was fully occupied with the preparation of other documents, including another eleven addenda of A/CN.9/WG.VI/WP.2, eight of which have already been submitted.

XII. Transition issues

A. General remarks

1. General rule as to pre-effective date transactions

1. In many cases, the rules embodied in new secured transactions legislation will be different from the rules in the law predating the legislation. Accordingly, such legislation should specify the date when it will enter into force (“effective date”).

2. As debts that are secured by rights in the debtor’s property are often payable over a long period of time, it is likely that there will be many rights created before the effective date of any new secured transactions legislation that will continue to exist, securing debts that are not yet paid, on the effective date of the new legislation. Therefore, another important decision that must be made with respect to any new secured transactions legislation is the extent, if any, to which the new legislation will govern transactions entered into prior to the effective date.

3. One possibility would be for the new legislation to apply prospectively only and, therefore, not to govern any transactions entered into prior to the effective date. While there is a certain logical appeal in such a solution, especially with respect to issues that arise between the debtor and the secured creditor, it would create significant problems. Foremost among those problems is that it would be quite difficult for parties to existing secured transactions to gain the advantages of the new legislation, which may be important in particular if the existence of rights created under the prior regime cannot be determined easily. Another problem is that, if the new legislation did not apply to pre-effective date transactions, priority conflicts between rights created before the effective date and those created after the effective date would be difficult to resolve and might be subject to old law indefinitely. As a result, significant economic benefits of the new legislation would be deferred for a substantial period.

4. Another possibility would be for the new secured transactions legislation to govern all secured transactions, including those already in existence, as of a designated effective date, with only such exceptions as are necessary to assure an effective transition to the new regime (see paras. 5-10). Such an approach would avoid the problems identified above.

2. Exceptions to the general rule

a. Disputes before a court or arbitral tribunal

5. When a dispute is in litigation (or a comparable dispute resolution system) at the effective date of the new legislation, the rights of the parties have sufficiently crystallized so that the effectiveness of a new legal regime should not change the outcome of that dispute. Therefore, such a dispute should not be resolved by application of the new legal regime.

b. Effectiveness of pre-effective date rights as between the parties

6. When a security right has been created before the effective date of new legislation, two questions arise regarding the effectiveness of that right between the debtor and the creditor. The first is whether a right that was not effective between the parties under old law, but would be effective if the new law applied should become effective on the effective date of the new law. The second question is whether a right that was effective between the parties under the old law but would be ineffective if the new law applied should become ineffective between the parties on the effective date of the new law. With respect to the first question, consideration should be given to making the right effective as of the effective date of the new law. With respect to the second question, a transition period might be created during which the right would remain effective between the parties, so that the creditor could take the necessary steps to make the right effective under the new law. At the expiration of the transition period, the right would become ineffective between the parties unless it had become effective under the new law.

c. Effectiveness of pre-effective date rights as against third parties

7. Different issues are raised as to the effectiveness against third parties of a right created before the effective date. As new legislation will embody public policy regarding the proper steps necessary to make a 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 to comply immediately with any additional requirements of the new law. Accordingly, a right that was effective against third parties under the previous legal regime but would not be effective under the new rules, should remain effective for a reasonable period of time (as determined by the new law) so as to give the creditor time to take the necessary steps under the new law.

8. If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new rules, the right should be effective against third parties immediately upon the effective date of the new rules. After all, presumably the parties intended effectiveness as between them, and third parties are protected to the full extent of the new rules.

d. Priority disputes

9. An entirely different set of questions arises in the case of priority disputes. If relative priority between two competing rights in encumbered assets has been established before the effective date of new rules, and nothing has happened that would change the priority other than the effective date having been reached, stability of relationships suggests that the priority established before the effective date should not be changed. If, however, something occurs that would have had an effect on priority even under the previous legal regime, there is less reason to continue to utilize old rules to govern a dispute that has been changed by an action that took place after the effective date of the new rules. Therefore, there is a much stronger case for applying the new rules to such a situation.

10. If the priority dispute is between one party whose right was established before the effective date and another party whose right was established after the

effective date, however, each party has an interest in application of the rules that were in effect when its interest was established. In such a case, while it is preferable to have the new rules govern eventually, it may be appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the old regime while that creditor takes whatever steps are necessary to maintain protection under the new regime. The transition rule might also provide that creditor with priority to the same extent as would have been the case had the new rules been effective at the time of the original transaction and those steps had been taken at that time.

B. Summary and recommendations

11. New secured transactions legislation should specify a date as of which it will enter into force.

[Note to the Working Group: The Working Group may wish to consider the extent to which the new legislation should apply to all transactions, including those already in existence.]

General AssemblyDistr.: Limited
12 April 2002

Original: English

**United Nations Commission
on International Trade Law**Working Group VI (Security Interests)
First session
New York, 20-24 May 2002**Security Interests****Report on UNCITRAL-CFA international colloquium on
secured transactions (Vienna, 20-22 March 2002)****Report of the Secretary-General*****Contents**

	<i>Paragraphs</i>	<i>Page</i>
Introduction	1-5	2
I. Economic background and scope	6-11	2
II. General approaches to security	12-13	3
III. Creation of security rights	14	4
IV. Publicity	15-18	4
V. Priority	19-24	6
VI. Pre-default rights and obligations of the parties	25-26	7
VII. Default and enforcement	27-29	7
VIII. Insolvency	30-33	8
IX. Conflict of laws	34-38	9
X. Transition	39	10

* This report is submitted late because it reports on a colloquium held only late in March and it is based on contributions by speakers, some of which were submitted much later.

Introduction

1. At its thirty-fourth session, the Commission decided to establish a working group with the mandate to develop an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, including the form of the instrument and the exact scope of assets that can serve as security.¹
2. At that session, the Commission emphasized the importance of the subject of security interests and the need to consult with representatives of the relevant practice and industry, and recommended that a colloquium be held before the first session of Working Group VI (Security Interests).²
3. The colloquium, organized jointly with the Commercial Finance Association (CFA), was held in Vienna from 20 to 22 March 2002. The colloquium was designed to provide a forum for dialogue among practitioners, international organizations and Government representatives on the work of the Commission on security interests.
4. It was attended by approximately fifty experts from around twenty countries, including officials of Governments and international organizations, such as the European Bank for Reconstruction and Development (EBRD), the International Monetary Fund (IMF) and the International Federation of Insolvency Professionals (INSOL). Speakers included experts who had significant experience in secured credit and insolvency law.
5. The present note provides a summary of the discussions that took place amongst the participants of the colloquium.

I. Economic background and scope

6. General support was expressed for a comprehensive scope of work that would encompass a broad range of assets as encumbered assets, a broad range of obligations to be secured and a broad array of debtors, creditors and credit transactions. It was noted that such an approach would be consistent with one of the key objectives of any efficient secured credit law, namely the need to permit parties to utilize the full value of their assets to obtain credit. However, a note of caution was struck that, to facilitate the completion of work within a reasonable timeframe and the wide adoption of the new regime, the scope of work should not be overly ambitious. It was also stated that, while immovables should not be covered, there were cases where a distinction might be difficult to draw (as was the case, for example, with fixtures and crops or enterprise mortgages that could include both movable and immovable assets).

¹ *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 358.

² *Ibid.*, para. 359.

7. It was emphasized that the new regime would be part of national law and as such would apply not only to international but also to purely domestic credit transactions.

Terminology

8. It was agreed that, while the focus should be on consensual security rights, priority conflicts with non-consensual security rights should also be addressed. It was, therefore, suggested that in any definition of “security right” reference should be made to both consensual (created by agreement) and to non-consensual (created by law or court judgement) security rights. It was also suggested that “security right” should be defined as a property right (i.e. a right *in rem*). As to the use of a uniform term “security right”, it was stated that it did not prejudice the issue whether one uniform, functional security right should be introduced to replace all security rights or quasi-security rights existing under national law or a specific security right that would coexist with the various security devices used in the various legal systems (see para. 14).

9. It was stated that a distinction should be drawn between the terms “debtor” (the person that owes the secured obligation) and “grantor” (the person that gives an asset as security) to cover cases where a third party gives an asset as security in favour of the debtor. It was also observed that use of these terms should be consistent and the reasons for using one or the other term should be clear.

Key objectives

10. General support was expressed for the view that that the economic impact of secured transactions legislation should be emphasized. It was agreed that the overall objective of any efficient secured transaction legislation should be to promote increased availability of low-cost credit.

11. As to the particular objectives of such legislation, a number of suggestions were made. One suggestion was that the importance of balancing the interests of debtors, creditors and affected third parties should be emphasized. Another suggestion was that key objectives should be clear, simple and concise. Yet another suggestion was that the need to avoid that secured creditors become exposed to liabilities, such as environmental liabilities, should be highlighted. Yet another suggestion was that the importance of coordination between the secured transactions and insolvency law regimes should be emphasized. Yet another suggestion was that, while recognizing party autonomy was an important objective, it was often limited by statutory limitations. In that connection, it was stated that reference should be made to the United Nations Assignment Convention, which contained principles with respect to certain statutory limitations. Yet another suggestion was that it should be made clear that transparency could be achieved in various ways and not only through registration.

II. General approaches to security

12. It was noted that possessory security rights that were traditionally regarded as providing strong security were sufficiently regulated. However, the law in many countries needed to be further developed with regard to non-possessory security rights, for which there was a clear economic need. A number of questions were

identified. One question was whether both possessory and non-possessory security rights should be covered and, if so, whether the same rules could apply to both. Another question was whether quasi-security devices (e.g. retention and transfer of title arrangements) should be covered. Yet another question was whether a new uniform, functional security right should be established or a new special type of right to coexist with other types of current security or quasi-security rights.

13. It was stated that both possessory and non-possessory security rights should be covered and treated in the same way, unless a different treatment was justified by practical realities as was the case, for example, with the issue of repossession of the encumbered asset by the secured creditor. In addition, it was observed that quasi-security rights should also be covered. Moreover, it was said that a new uniform, functional, comprehensive security right in all types of asset should be introduced. On the other hand, it was pointed out that replacing existing security devices with a new uniform, functional security right might not be feasible or even desirable. In addition, it was said that covering retention and transfer of title arrangements in a secured transactions project might be particularly problematic and needed to be considered very carefully with a view to identifying advantages and disadvantages. It was agreed that the costs and benefits of a comprehensive, functional approach as compared with a specific approach should be explained in detail.

III. Creation of security rights

14. It was stated that it should be possible to give any type of asset as security and to secure any type of obligation. Particular reference was made to the need to allow security to be created in assets acquired after the conclusion of the security agreement and in changing pools of assets in order to secure even obligations arising after the conclusion of the security agreement and obligations in revolving credits. It was recognized that, in order to achieve that objective, it was necessary to adapt requirements as to the description of the encumbered asset or the secured obligation. It was also observed that policy choices to protect certain debtors (e.g. consumers) or unsecured creditors could be accommodated by way of limited exceptions. For example, household goods should not be made subject to security other than that necessary to secure their purchase price. Furthermore, it was said that a modern secured transactions regime should allow security to be created over an asset, whether the grantor had ownership or a limited right (e.g. a usufruct or a pledge). In that respect, it was pointed out that the object of security was not the asset itself but the grantor's right in the asset.

IV. Publicity

15. The discussion focused on whether an effective secured transactions regime dealing with non-possessory security rights required the establishment of a system in the context of which notices could be filed to alert potential financiers of the possible existence of security rights and to provide a basis for resolving conflicts between competing claims in the same assets. One view was that such a public registry was unnecessary. It was stated that fraudulent antedating of security instruments could be dealt with through less costly and complex requirements. It was also observed that the appearance of false wealth created by the debtor's continued possession of the encumbered assets was not a valid concern. It was pointed out that, in a credit-dominated economy, parties ought to know that an

enterprise's or even a consumer's assets were likely to be encumbered or be subject to a quasi-security device (e.g. lease or title retention).

16. In addition, it was said that parties should be presumed to be acting honestly and in good faith. The law should encourage that behaviour by providing for civil and even criminal penalties for dishonest or bad faith behaviour. Potential financiers could be adequately protected by the debtor's representations as to the existence of security rights combined with the debtor's promise not to give the same asset as security to another creditor without the consent of the secured creditor. It was also stated that the establishment and operation of a filing system would add cost and complexity to secured transactions. Moreover, it was observed that the filing system might inappropriately disclose confidential information even to competitors and thus harm debtors. Furthermore, it was said that priority rules based on filing of a notice about a transaction could inappropriately favour bank over supplier credit. Such supplier credit was said to be in many countries much more substantial in value and importance for the economy than bank credit.

17. In response, it was observed that anti-fraud and date-certain features were incidental partial benefits, but not the primary function of the filing system, which was to alert potential financiers of any existing security rights and to serve as a tool for resolving priority conflicts. It was also said that potential financiers could not rely only on the debtor's representations as to any existing security rights. In a global market, debtors may not be known to creditors or may not yet have established a relationship of trust with creditors. In that connection, it was pointed out that misrepresentations were not necessarily the result of dishonesty or bad faith. For example, in the absence of expert advice, a debtor might not easily understand that the fact that it has granted security over a general category of assets to one creditor precluded the debtor from offering specific assets from that category as security to other creditors. Miscalculation of the value of assets was also said to be a normal occurrence in practice that was not the result of dishonesty or bad faith.

18. As to the costs of establishing and operating a filing system, it was stated that such a system had been established and was working at a minimal cost even in some of the least developed countries of the world. It was also observed that one of the key characteristics of the filing system was low, flat filing fees. A system with high, *ad valorem* filing fees was generally found to be completely undesirable. In addition, with regard to the concern that a filing system might inadvertently disclose confidential information, it was observed that an efficient notice-filing system disclosed very little information. In any case, that information was not confidential, but was available on balance sheets or through various credit-reporting agencies. On the other hand, it was pointed out that, if such information was available, a filing system was not necessary and would unnecessarily increase transaction costs. Disagreement was expressed with that view since credit reporting systems could not play the function of alerting potential financiers to the possibility of the existence of any security rights or the function of resolving priority conflicts. It was also pointed out that there was a cost associated, in particular in the context of an insolvency proceeding, with determining priority in a legal system that did not provide sufficient information about competing claims. Moreover, as to the concern expressed as to the relevant priority of supplier credit, it was observed that even in countries with a notice-filing system priority was given to suppliers as long as they filed a notice about their claim. In that context again, the concern about publicizing

a business relationship was raised in particular with respect to retention of title arrangements (see paras. 20-22).

V. Priority

19. It was stated that a system providing priority to different creditors permitted the use of the same asset as security for credit granted by multiple creditors. That result would facilitate the full utilization of the value of assets for the purpose of obtaining credit, which was said to be one of the key objectives of any efficient secured transactions regime. It was also observed that that objective could most effectively be achieved by a first-to-file priority rule. However, several objections were raised.

20. One objection was that requiring suppliers with a retention of title to secure payment of the price to file a notice each time they supplied goods would unnecessarily add cost and complexity to the transaction, while encouraging irresponsible or even dishonest behaviour on the part of the debtor or other grantor. It was stated that supplier credit was important for the economy and should not be disrupted. It was, therefore, suggested that a first-to-conclude-a-contract rule would be more appropriate. A creditor providing general credit should be expected to rely on the debtor to accurately describe to the general secured creditor the rights that the debtor may have granted to a supplier. Failure of the debtor to accurately report such information to the general secured creditor should make the debtor subject to civil or even criminal penalties.

21. In response, it was stated that suppliers should not need to file a notice each time they supplied goods but that one notice should be sufficient for goods provided during the duration of the contract. It was also observed that the filing fee should be nominal reflecting only the operating cost of the filing office. In addition, it was said that the absence of any notice had also cost implications since it was bound to create uncertainty. Moreover, it was stated that super-priority could be given to suppliers in order to protect supplier credit. Such an approach would be based on the fact that, once notice was filed about the supplier's rights, other lenders, whether previous or subsequent, would be on notice about the supplier's super-priority. As to the extent of the priority of supplier credit, it was stated that whether it would extend to proceeds (e.g. receivables) of the encumbered assets (e.g. inventory) would depend on whether the legislator wanted to promote more receivables as opposed to inventory financing.

22. As to the suggestion that a general creditor should rely on the representations of the debtor, several countervailing considerations were mentioned. One consideration was that it was questionable whether the secured creditor could rely on the debtor to know accurately and specifically the scope and nature of the rights that it might have given to the supplier. It was stated that relying on the debtor assumed a certain quality of record-keeping which especially with a company in financial distress might not be available or readily accessible. Another consideration was that relying on the debtor's description of the rights given to the supplier might not be safe as there was the possibility that the supplier might have a different view of the scope and nature of its rights against the debtor and its assets from that given by the debtor. Yet another consideration was that while criminal penalties might be severe, their implementation might not be sufficiently certain since the standards required to find liability under criminal law were normally greater than under civil

law. Lowering those standards was said to be inappropriate. In addition, criminal penalties from the secured creditor's perspective were not a substitute for repayment of its debt pursuant to recourse to the property of the debtor.

23. On the other hand, it was stated that a secured transactions regime that would include retention of title rights (purchase-money security rights) would be complex. In response, it was stated that the nature of that financing was relatively simple and straightforward and that suppliers and secured creditors were easily identified for purposes of the debtor providing the applicable information to the general secured creditor. That fact was confirmed also by the absence in many countries of a requirement that suppliers comply with the notice filing to establish priority. It was also observed that the absence of a filing might involve additional evidentiary burdens. The, supplier, for example would have to prove that it had a valid reservation of title and the date such rights were established. The possibility was also raised that rights in property to secure debt, such as pursuant to a retention of title by a seller of goods, might continue to exist as a separate category of rights, but could still be made subject to a filing system as a method of establishing priority relative to other types of security rights.

24. The need to grant super-priority to certain non-consensual rights (e.g. of the State for taxes or of employees for wages) was also emphasized. Divergent views were expressed as to whether notice should be filed about such rights.

VI. Pre-default rights and obligations of the parties

25. There was general support for the view that that any default rules should be limited to those that were absolutely essential and those that the parties would have most likely have agreed to. Some doubt was expressed as to the need for a rule providing that the encumbered assets should be insured. It was noted that in some jurisdictions insurance was not made available for many types of assets.

26. The need to distinguish between rights and obligations for possessory and non-possessory security was questioned in view of the fact that some of the default rules applied to both possessory and non-possessory security (e.g. the secured creditor's right to assign the secured obligation). It was also noted that the right to repledge conferred on the secured creditor referred to the right to repledge the security right in the encumbered asset rather than the encumbered asset itself.

VII. Default and enforcement

27. The importance of providing for effective enforcement of security rights was emphasized. It was stated that the best law for the creation of security rights would be of no practical use if secured creditors were unable to realize the economic value of their rights. In that connection, attention was called to the need to review the institutional context in which enforcement took place and to assess frankly the efficiency of procedures used by institutions such as the civil courts. It was also observed that reference should be made also to arbitral tribunals and other non-judicial bodies.

28. The diversity of possible mechanisms for realizing the economic value of security rights was also emphasized. With respect to procedures for initiating enforcement, it was stated that there were several alternatives. Alternatives mentioned included enforcement by the secured creditor without prior court intervention, enforcement by the creditor with executory title, registered with a court or notarized, and enforcement based on presumptions or a limitation of defences in cases where judicial action was required. Some preference was expressed in favour of enforcement by the creditor without prior court intervention, with executory title issued by a notary as the second-best solution. It was also stated that, if judicial action were required, debtor defences should be limited to avoid dilatory practices. For example, in the case of a non-possessory right the only defence against repossession should be that there was no default (and not the amount owed or other details). In addition, it was observed that the secured creditor should be able to sell the encumbered assets at the market price in the place where the assets were located. Moreover, it was stated that it was essential to ensure that assets would be converted into cash in a timely manner in order to avoid loss of value.

29. Attention was also called to the need to provide prompt and effective ways for a secured creditor to take possession of the encumbered assets following default in the case of a non-possessory security right. In other respects, however, it was not thought necessary to distinguish between possessory and non-possessory security rights. The view was expressed that the potential for abuse by secured creditors should also be considered. The example was given of agreements between debtors and secured creditors that in some jurisdictions were treated differently in the sense that pre-default agreements were void, while post-default agreements were valid and enforceable.

VIII. Insolvency

30. It was agreed that both secured transactions and insolvency regimes were concerned with debtor-creditor relationships and that both regimes exercised an important influence on corporate governance in the sense that they both had an interest in credit discipline and responsibility for debt. It was also agreed that there were also areas of tension between the two regimes, such as, for example, the different approaches to debt, to the extent that each regime upheld different rights and had different stakeholder constituencies.

31. It was stated that the insolvency viewpoint was not adverse to and should support a secured transactions regime that enabled the consensual “creation” of appropriately defined third-party security rights interests in property. The need was identified to clarify and to provide certainty in the classification of “quasi-security devices”, such as retention of title and financial leases. It was pointed out that the greater the range of property over which security might be taken, the greater the possibility of assessing the ability of a borrower to service a borrowing (that reduced over-indebtedness and consequent insolvency).

32. In addition, it was observed that an insolvency viewpoint also supported a notice-filing system that would be all embracing and provide a certain, efficient and cost-effective search base. It was said that a filing system provided an insolvency representative with certainty by facilitation the identification of encumbered assets, the secured obligation and the secured creditor. It would also assist an insolvency

representative in determining validity and enforceability and in determining priority between competing security rights over the same property. Within the context of registration, however, two issues were mentioned as requiring particular consideration. The first concerned whether a secured transaction or an insolvency regime should emphasize the need for filing by, for example, avoiding or otherwise rendering ineffective unregistered secured property rights for failure to file or otherwise perfect. It was mentioned that that approach was taken in some insolvency and secured transactions regimes. The second issue concerned the applicability to secured transactions, otherwise validly concluded, of provisions dealing with the avoidance of antecedent preferential and fraudulent transactions as found in most insolvency law regimes.

33. With regard to the actual impact of the commencement of an insolvency process upon secured creditors, it was suggested that it might be necessary to distinguish between liquidation and rescue processes. Under the former, an insolvency viewpoint would generally support the view that in a liquidation process there should be no lengthy or, indeed, any stay or suspension on enforcement of a security right. However, in relation to a rescue process, there should be a stay or suspension on enforcement of a security right, because of the possibility of enhanced value through rescue and of avoiding dismemberment of the estate. That should not, however, affect or threaten the substantive rights of secured creditors, but rather postpone the exercise of immediate enforcement rights. More difficult issues mentioned included: binding a secured creditor to a rescue plan; abuse of a rescue process by debtors; post-insolvency commencement funding; and the possible creation of a “super priority” that might affect holders of existing security rights. The need to coordinate enforcement and insolvency responses with the work of the Working Group on Insolvency Law was also emphasized.

IX. Conflict of laws

34. The discussion focused on the law that should govern the creation, publicity and priority of security rights over receivables and inventory. With respect to receivables, the appropriateness of the conflict rule contained in the United Nations Assignment Convention (leading to the application of the law of the grantor’s location) was confirmed. It was observed, however, that for certain categories of intangibles, such as bank deposits and securities accounts, a different approach might need to be taken.

35. With respect to the law applicable to security rights over tangible property, it was noted that there were two alternatives. The first alternative was the traditional rule, which subjected creation, publicity and priority issues to the law of the State in which tangible assets were located (*lex situs*). The second alternative was a two-fold rule according to which creation and publicity would be governed by the law of the location of the grantor but priority would be governed by the *lex situs*.

36. A number of concerns were raised with respect to the second alternative. One concern was that such a rule would run counter to the expectations of third parties that would expect the *lex situs* to apply to all property aspects of a security right in tangible property. Another concern was that a two-fold rule might be difficult to apply if the legal system governing priority was based on publicity concepts that did not exist under the law of the location of the grantor. However, in support of such a

bifurcated rule it was stated that departing from the traditional rule would have the benefit of applying the same law to the creation and publicity of a security right in both tangible and intangible property.

37. As to the law applicable to enforcement, it was suggested that most of enforcement-related issues should be governed by the *lex situs*, since enforcement was necessary when the debtor did not voluntarily perform its obligations and the assistance of local authorities was required. It was also stated that enforcement might not be treated as a single issue but a series of issues. It was also observed that some of those issues might be subject to party autonomy (e.g. disposition of encumbered asset by agreement of the parties), while with respect to other issues that raised public policy issues an objective connecting factor might need to be used.

38. With respect to the law applicable to insolvency proceedings, it was stated that, in the case of assets located in the State where the main insolvency proceeding was opened, the widely accepted rule, providing for the application of the law of that State, should be adopted. As to the situation in which assets were located in another jurisdiction, it was stated that there was no generally accepted solution and the matter needed to be discussed with a view to providing guidance to States.

X. Transition

39. It was stated that the contents of any transition rules would depend on the circumstances prevailing in each State and that, therefore, no guidance could be provided to States. It was recognized, however, that the matter should be discussed since, in the absence of adequate transition rules, either parties might not be able to obtain the full benefits of new legislation or existing relationships might be disrupted.

General Assembly

Distr.: Limited
24 April 2002



Original: English

United Nations Commission on International Trade Law

Working Group VI (Security Interests)
First session
New York, 20-24 May 2002

Security Interests

Draft legislative guide on secured transactions

Note by the Secretariat*

1. At its thirty-fourth session, the Commission decided to entrust a working group with the mandate to develop “an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, such as the form of the instrument, the exact scope of the assets that can serve as collateral ...”.¹ Emphasizing the importance of the matter and the need to consult with representatives of the relevant industry and practice, the Commission recommended that a two- to three-day colloquium be held.²

2. In order to facilitate the work of the Working Group, the Secretariat has prepared a first, preliminary draft Legislative Guide on Secured Transactions (A/CN.9/WG.VI/WP.2 and Addenda 1 to 12). An international colloquium on secured transactions was also held in Vienna from 20 to 22 March 2002 (the report of the colloquium is contained in document A/CN.9/WG.VI/WP.3). Following the colloquium, the Secretariat received from the European Bank for Reconstruction and Development (EBRD) comments on the first preliminary draft of the Legislative Guide. These comments are reproduced in the annex to this note.

* This note is issued later than the required ten weeks prior to the start of the meeting because it contains comments submitted to the secretariat of the Commission a few days prior to its issuance.

¹ Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 (A/56/17), para. 358.

² Ibid., para. 359.

Annex

Comments by the European Bank for Reconstruction and Development (EBRD)

1. As part of its legal reform work undertaken in the last ten years, secured transactions constitutes an area of particular importance to the European Bank for Reconstruction and Development (EBRD). When the EBRD was founded in 1991 to participate in the reconstruction efforts in the former communist countries of Central and Eastern Europe, it was immediately clear that investments by the Bank and others in the region would be seriously impeded if the legal framework necessary to secure these investments was not in place. Such a framework could not be achieved by the simple enactment of a new law but required an entire re-thinking of the legal provisions applicable to security rights over property and the effective implementation of such policy reform. This process started slowly and has intensified over the years. Every country in the region has since undertaken reform of the subject in one way or another.

2. The EBRD has itself contributed to this process in many ways. For example, it has developed a template for reform. The EBRD Model Law for Secured Transactions, was published in 1994 and the EBRD Ten Core Principles for Secured Transactions Law, were published in 1998. In addition, the EBRD has conducted an assessment of progress in the region. The EBRD Regional Survey of Secured Transactions Laws, was published for the first time in 1999 and has been regularly up-dated ever since. Moreover, the EBRD has contributed to progress directly by providing technical assistance to a number of countries for the reform of secured transactions law and its implementation. It is thus of great interest to the EBRD to follow and participate to the new initiative of UNCITRAL in this field. This initiative constitutes an opportunity to expand and develop the work that has been carried out in this field by the EBRD, the Asian Development Bank (ADB), the International Bank for Reconstruction and Development (the World Bank), and other institutions working on international legal reform. UNCITRAL's work can have an immense impact on nations globally. Moreover, despite the non-binding nature of a Legislative Guide, as opposed to a Convention, we believe that it can have more impact on law-reformers throughout the world, as it would certainly be the most advanced and comprehensive document on secured transactions legal regimes to date.

3. The EBRD sees its role as that of an active observer, providing examples of the issues faced in the legal reform process, and the way they have been resolved in different jurisdictions of Central and Eastern Europe. The EBRD would also stress the economic benefits to be derived from an efficient secured credit market, which should not be sacrificed to traditions and theoretical concepts. Practical problems in the area of secured transactions, and the difficulties and economic inefficiencies of solving them under existing legislation (if it is possible at all) should be the trigger of any legislature to undertake reform in this field, and thereby to refer to the future UNCITRAL Legislative Guide. It is practitioners who are often best placed to put forward the persuasive arguments needed to convince lawmakers that traditional rules and practices have to be changed if they are to serve modern economic needs.

4. Having read the first preliminary draft of the Legislative Guide, which is now before the Working Group, and participated in the Colloquium, we would like to emphasise certain issues that have featured in our work in transition countries.

a. The Guide should stimulate change

5. The objective of developing a legislative guide is that the resulting product should stimulate change. It would be disappointing if the Guide were read and endorsed by those countries that already have an effective legal regime for secured transactions, but studiously ignored by those countries where there is a strong case for change. It is interesting to note that the Guide is likely to be as relevant and useful for many developed countries, as it will be for developing countries and countries with economies in transition. It would equally be disappointing if the need for compromise within the Working Group lead to the reform policies being diluted to the extent that the message of the Guide would no longer be clear or compelling.

6. Whereas it is inevitable that the Guide takes the form of a relatively long document with a mine of detail, it is crucial that it should emphasise a set of recommendations that concentrate on the essential results that have to be obtained, with an indication (where appropriate) of alternative (yet effective) means by which those results may be achieved. We find, for example, that the basic requirements for the creation of the security interest and the elements that should be present in any given regime need to be spelled out very clearly. The Guide cannot be limited to a presentation of the various options present in existing regimes as part of a “pick and choose” exercise. It is necessary to draw a distinction between those concepts or features of the system that are essential to the whole reform process (for example, the ability to encumber, without additional formalities, assets which are identified generally or are acquired in the future), and those that are of less importance and may be introduced or refined at a later stage, depending on the need and inclination within the country concerned. Conversely, the Guide should not seek to impose solutions, even in matters of practical detail, where other approaches might be adopted (e.g. extending the security to the proceeds of sale of the encumbered asset; purchase money security; method of giving certainty to the date of the security agreement; renewal of filing).

b. The Guide should not polarise Common Law systems and Civil Law systems

7. It is desirable that the Guide, while acknowledging the division between Civil Law legal tradition and Common Law legal tradition, does not in practice “ostracise” some countries, leaving them feeling excluded from reform efforts and needs because of their seemingly “different” legal tradition. One principle which has guided the work of the EBRD in this field has been to draw on many useful solutions that have developed in Common Law systems to accommodate modern financing techniques in a manner which is compatible with the Civil Law traditions underlying many Central and Eastern European legal systems. Our experience has confirmed our belief that legal tradition is no obstacle to reform in the field of secured transactions towards an economically efficient regime, provided that the determination to reform exists, and that variations and accommodations can be made to acknowledge difference in institutions, style and accepted practice.

8. The Guide's message must remain simple (but not simplistic) so that its substance may be readily understood by those contemplating reform. If the Guide is too complex or obscure in style, or seems to be too heavily inspired by an existing system, which may not appeal as a model to all countries, then it will not be used. It must also be remembered that it is likely to be translated and used in many different legal reform contexts, hence the need for clarity and plain, unbiased language.

c. The Guide should emphasise the distinction between a formal and a functional approach

9. The need for a functional analysis of secured transactions is evident as noted throughout the Guide with various justifications, but without any clear explanation. We consider that this is one of the most difficult issues, as well as one of the most controversial, and that it must be addressed openly. There are strongly held views for and against adopting a functional approach to security interests (which encompasses any transaction whose function is to provide security to one party for re-payment of an underlying obligation, regardless of the form and the legal technique adopted by the parties). Reform that entails adopting a functional approach also implies a major review of the law on obligations and property, and some fundamental changes in the approach to legal and practical issues. Such reform cannot be a question of a relatively self-contained introduction of non-possessory security interests that would provide the market with a new type of security adapted to its needs. The objective becomes far more comprehensive, and both the reform and its implementation will require more extensive preparation and resources. Reform-makers need to understand this very clearly, and balance carefully the advantages and disadvantages of adopting a fully functional approach. Based on our experience, we would suggest that a formal approach (encompassing only those transactions that are in the form required for the creation of security) could serve the economic objectives of secured transactions reform, while leaving considerable scope to encourage convergence, for example, by introducing similar rules for quasi-security transactions on the questions of publicity, priority and enforcement.

10. The Guide needs to be very clear on this point, in its terminology, in the definition of the key objectives and in the basic approach to security issues, rather than making an implicit assumption that a functional approach should be adopted, without proper explanation.

d. The Guide should remain open to the concept of a secured transactions regime encompassing movable and immovable property

11. Another implicit assumption, which is made in the Guide, is the strict separation between movable and immovable assets. This separation, although it may make perfect sense in some legal regimes, may not always be appropriate. On the contrary, in some cases, there can be a very good case for a country to attempt to reform both areas at the same time and to submit security over movable and immovable assets to similar rules. The Guide should leave this option open and should give general guidance as to how reform encompassing both movable and immovable assets may be successfully developed.

e. The need for publicity of the security interest must be made absolutely clear

12. The Guide should leave no doubt that a modern regime for secured transactions requires a system of publicity, which puts third parties on notice that a security interest over defined assets has been created by the debtor in favour of a creditor, and which can also resolve priority issues. This should be reflected, in particular, in the key principles of the Guide. Although the absence of publicity has not prevented some economies from developing a secured credit market, it is contradictory, in an open-market economy, to encourage greater use of assets as security and, at the same time, to allow the existence of that security to be concealed from other persons in the market. The principle of publicity is being slowly but steadily adopted throughout the region where the EBRD operates. Difficult policy choices for the implementation of publicity have to be made, such as the legal effects of registration and the non-authentic nature of registered information, and these must be clearly presented in the Guide, as the current draft accepts.

f. The Guide needs to take a clear stance on enforcement

13. Enforcement of a security interest tests the ultimate *raison d'être* of the security. If enforcement does not enable quick and effective realisation of the encumbered assets and payment of the secured creditor, the reliance on the security as a means to reduce credit risk is severely undermined. However, this may be the most difficult part of the reform because the enforcement regime will necessarily be closely interlocked with the existing rules on civil procedure on matters, such as debt collection (enforcement of contracts) by judicial action, possessory actions, provisional measures over assets and enforcement over movable and immovable assets. Moreover, here, more than in any other area, the existence of institutions and their functioning (or not) will be key to the success of the reform. For example, the court system, its capacity, way of functioning and the risk of corruption, the existence and effectiveness of other professions that can play a key role in enforcement procedures, (especially when they are conducted privately, such as through judicial enforcement officers, notaries, other lawyers, auctioneers and other experts) will be key to the success of the reform.

14. Because of the importance of enforcement and the limitations on adopting a general prescriptive approach when so many external factors must be taken into account, it is essential to refer to the system's objectives in terms of timing and efficiency. In this connection, it is important to have regard to the realistic expectations of what can be achieved in a country, as opposed to imposing solutions that may work in some jurisdictions but not in others due to the differences in procedural law and institutional framework.

15. Views are often polarised when discussions on enforcement focus on the involvement of the courts. The approach of allowing parties broad rights to resolve issues themselves and reserving the role of the courts as a fall-back position has much to commend it but often runs directly against entrenched traditions and perceptions of the court's role. In many countries, there is a strong expectation of court involvement. Where there are deficiencies in the way the court system operates, an inefficient court-dominated realisation process may be seen as a lesser

evil than a self-help regime where the courts are not capable of assuring adequate protection against abusive or wrongful actions by the creditor. The way towards workable solutions is most often found by a reasoned exploration of the different methods by which enforcement can be achieved, the potential economic impact of each method (and the resultant effect on the perception of security) and the different available means of ensuring a fair balance between the justifiable interests of debtor and creditor.