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Draft Guide to Enactment of the UNCITRAL Model Law on Secured Transactions

Note by the Secretariat

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Chapter II. Creation of a security right

A. General rules

1. This chapter, and several other chapters, contain a section A with general rules and a section B with asset-specific rules. This approach is followed to avoid overloading the general rules with asset-specific details. The general rules apply to all assets, but, in relation to certain types of asset, they apply subject to the asset-specific rules. The enacting State may wish to consider whether to include in the general rules of each chapter of its law cross-references to the asset-specific rules in that chapter or a provision that states explicitly that the general rules in each chapter are subject to the asset-specific rules in that chapter (see footnote 4 of the Model Law). The rules in each chapter are divided between general and asset-specific rules also to make it easier for an enacting State to leave out of its law any asset-specific rules that they may not need. If an enacting State concludes that it does not need all of the asset-specific rules, it may decide to leave some of them out of its law. However, not all asset-specific rules should be omitted. For example, some asset-specific rules deal with core commercial assets such as receivables and no enacting State should omit them from its enactment of the Model Law.

Article 6. Creation of a security right and requirements for a security agreement

2. Article 6 is based on recommendations 13-15 of the Secured Transactions Guide (see chap. II, paras. 12-37). Its purpose is to deal with the creation of a security right, as well as the form and the minimum content of a security agreement, so as to enable parties to obtain a security right in a simple and efficient manner (see Secured Transactions Guide, rec. 1, subpara. (c)). A security right is created by agreement, for the content of which there are no requirements other than those listed in paragraphs 3 and 4, and for the conclusion of which no terms of art or special words need be used.

3. Under paragraph 1, an agreement is sufficient to create a security right, if the grantor has either a right in the asset to be encumbered or the power to encumber it. The grantor has the right to encumber an asset where the grantor is the owner of the asset. Where the grantor is in possession of the asset on the basis of an agreement with the owner, such as a lease agreement, the grantor has a right to create a security right in its rights under the lease agreement. Also, the creditor of a receivable has the power (rather than the right) to create a security right in the receivable, even if it has already transferred the receivable. That power is implicit in the fact that the third-party effectiveness and priority rules of the Model Law apply to outright transfers of receivables by agreement. If a transferee in an outright transfer of a receivable does not make its right effective against third parties before a subsequent competing secured creditor does so, then the transferee will not have priority over the competing secured creditor. If the transferee made its right effective against third parties before the subsequent competing secured creditor, then technically the transferor will still have the power to encumber (or transfer) the receivable in favour of the subsequent secured creditor, but as a practical matter there would be no value left in the receivable for the subsequent secured creditor to benefit from. It should also be noted that, in line with article 13, paragraph 1, the creditor of a receivable to which that article applies has a right in the receivable or the power to encumber it despite any anti-assignment agreement with the debtor of the receivable.

4. Paragraph 2 clarifies that a security agreement may provide for the creation of a security right in future assets (i.e. assets produced or acquired by the grantor after the conclusion of the security agreement; see definition in art. 2, subpara. (n)). However, the security right is created in the future assets only when the grantor acquires rights in them or the power to encumber them.

5. Paragraph 3 states that writing is required for a security agreement and sets out what the writing needs to contain. Written form provides objective evidence of the existence of a security agreement and its key terms (for other reasons why a security agreement might be required, see Secured Transactions Guide, chap. II, para. 30). From the two alternative wordings set out in the chapeau of paragraph 3 within square brackets, the enacting State may wish to select the one that is most fitting to its contract law and its law of evidence. If the enacting State retains the words "concluded in", a security agreement that is not in written form will not be effective, except as provided in article 6, paragraph 4. For example, a written offer by the grantor that is subsequently accepted by the secured creditor by conduct would not be a sufficient security agreement under this option. If the enacting State retains the words "evidenced by", however, a security agreement that is not in written form may still be effective if its terms are evidenced by a written document that is signed by the grantor (e.g. an oral agreement that is subsequently confirmed in writing).

6. Depending on what it considers as the most efficient financing practices and reasonable assumptions of credit market participants, the enacting State may wish to consider whether to retain paragraph 3 (d). One approach is to retain paragraph 3 (d) to facilitate the grantor's access to secured financing from other creditors in situations where the value of the assets encumbered by the prior security right exceeds the maximum amount indicated in the notice registered with respect to that right. Another approach is to leave out paragraph 3 (d), in order to facilitate the grantor's access to credit by the first secured creditor (for the comparative advantages and disadvantages of the two approaches, see Secured Transactions Guide, chap. IV, paras. 92-97, and Registry Guide, paras. 200-204). If paragraph 3 (d) is retained, the enacting State will need to make provision for the maximum amount to appear on the notice (see art. 8, subpara. (e), of the Model Registry Provisions). Otherwise the benefits of retaining paragraph 3 (d) may not be realized because the maximum amount may not be known to potential subsequent creditors (art. 24, para. 7, of the Model Registry Provisions would also need to be retained to deal with an error in stating the maximum amount on the notice).

7. Under paragraph 4, where the secured creditor is in possession of the encumbered asset, an oral security agreement with the grantor is sufficient. The fact that the secured creditor is in possession of the encumbered asset is itself evidence that the asset may be encumbered (see Secured Transactions Guide, chap. II, para. 33).

Article 7. Obligations that may be secured

8. Article 7 is based on recommendation 16 of the Secured Transactions Guide (see chap. II, paras. 38-48). It is primarily intended to ensure that future, conditional and fluctuating obligations may be secured. The main reason for this approach is to facilitate modern financing transactions, in the context of which an agreement may provide that disbursements of funds by the secured creditor may be made at different times depending on the needs of the grantor (e.g. revolving credit facilities for the grantor to buy inventory). This approach does not necessarily mean that grantors may not be protected from excessive economic commitments. For example, depending on the grantor's financing needs, a maximum amount may be set for which the security right may be enforced (see art. 6, para. 3 (d), and para. 6 above).

Article 8. Assets that may be encumbered

9. Article 8 is based on recommendation 17 of the Secured Transactions Guide (see chap. II, paras. 49-57 and 61-70). It is primarily intended to ensure that future movable assets, parts of movable assets and undivided rights in movable assets, generic categories of movable assets, as well as all the movable assets a person has, may be the subject of a security agreement (for the time when a security right in future assets is created, see art. 6, para. 2, and para. 4 above).

10. The fact that future movable assets may be subject to a security right does not mean that statutory limitations on the creation or enforcement of a security right in specific types of movable asset (e.g. employment benefits in general or up to a specific amount) are overridden (see art. 1, para. 6).

11. The fact that all the movable assets a person has may be subject to a security right so as to maximize the amount of credit that may be available and improve the terms of the credit agreement does not mean that other creditors of the grantor are necessarily unprotected. The protection of other creditors (within and outside insolvency proceedings) is a matter of other law and is referred to in articles 35 and 36 of the Model Law.

Article 9. Description of encumbered assets and secured obligations

12. Article 9 is based on recommendation 14 (d) of the Secured Transactions Guide (see chap. II, paras. 58-60). In view of its importance, the standard for the description of encumbered assets in a security agreement is presented in a separate article (rather than in art. 6, para. 3, as it was done in rec. 14 (d) of the Secured Transactions Guide, on which art. 6, para. 3, of the Model Law is based).

13. Paragraph 1 sets out the general standard that must be met in the description of encumbered assets and the secured obligations for a security agreement to be effective (the description must reasonably allow their identification). Paragraph 2 is intended to ensure that, if a security right is created in a generic category of assets under article 8, subparagraph (c), a generic description in the security agreement, such as “all inventory” or “all receivables”, is sufficient to meet the standard in paragraph 1 (see Secured Transactions Guide, chap. II, paras. 58-60). Paragraph 3 sets out the same standard for the description of secured obligations.

Article 10. Rights to proceeds and commingled funds

14. Article 10 is based on recommendations 19 and 20 of the Secured Transactions Guide (see chap. II, paras. 72-89). Paragraph 1 is intended to ensure that, unless otherwise agreed by the parties (as this article is not listed in art. 3 as a mandatory law rule), a security right in an asset automatically extends to its identifiable proceeds (for the definition of “proceeds” see art. 2, subpara. (bb)). The rationale for this rule is that it reflects the normal expectations of the parties and ensures that the secured creditor is sufficiently protected. This protection includes the secured creditor’s right to enforce its security right both in the encumbered assets (provided that the transferee acquired its rights in the assets subject to the security right) and in the proceeds, although only up to the amount of the secured obligation. Otherwise, a grantor could effectively deprive a secured creditor of its security by disposing of the encumbered assets either to a person who would take free of the security right or to a person from whom those assets could not easily be recovered.

15. By way of example, where the original encumbered asset is inventory, receivables generated from the sale of the inventory are proceeds (if they are identifiable). If upon payment of the receivables the funds received are deposited in a bank account, the right to payment of the funds credited to the bank account is also proceeds (proceeds of proceeds of the inventory). So, too, is the right to payment pursuant to a negotiable instrument (e.g. a cheque issued by the holder of that bank account to buy new inventory), as well as a negotiable warehouse receipt issued by the warehouse in which new inventory may be stored. It should be noted that, if the description of the encumbered asset is comprehensive and covers all assets received in respect of the original encumbered asset, they will all be original encumbered assets, and thus article 6, which governs the creation of a security right in original encumbered assets would apply, and not article 10.

16. Paragraph 2 introduces an exception to the identifiability requirement in paragraph 1. A security right in an asset extends to its proceeds in the form of funds that are commingled with other funds even though the funds that are proceeds cannot be identified separately from the funds that are not proceeds (see para. 2 (a)).

Paragraph 2 (b) limits that security right to the value of the proceeds immediately before they were commingled. So, if a sum of €1,000 is deposited in a bank account and at the time of enforcement the bank account has a balance of €2,500, the security right extends only to the sum of €1,000.

17. Paragraph 2 (c) deals with situations in which the balance in the bank account fluctuates and, at some point of time, is less than the value of the proceeds deposited (in the example set out in the previous paragraph, less than €1,000). In such a case, the security right extends only to the lowest value between the time when the proceeds were commingled and the time the security right in the proceeds is claimed. So, if in the example given in the previous paragraph, the balance in the account immediately after the proceeds were deposited was €1,500, then it went down to €500 and at the time of enforcement was €750, the security right extends only to €500 (i.e. the lowest intermediate balance). The rationale for this approach is that, if the balance of a bank account falls, funds deposited later are unlikely to be proceeds of the original encumbered assets.

18. Where funds in a bank account are original encumbered assets, and the funds are transferred into another bank account and mixed with other funds in that other account, then the funds as transferred into that other account will be "proceeds" of the original funds, and thus the rules in article 10 will apply.

Article 11. Tangible assets commingled in a mass or transformed into a product

19. Article 11 is based on recommendations 22 and 91 of the Secured Transactions Guide (see chap. II, paras. 90-95 and 100-102, and chap. V, paras. 117-123). It accomplishes two related objectives. First, it transforms a security right in a tangible asset that is commingled in a mass or transformed into a product into a security right in the mass or product. Second, it limits the value of that security right by reference to the quantity (in the case of a mass) or the value (in the case of a product) of the tangible asset commingled in the mass or product. Article 33 then addresses situations in which more than one secured creditor has a claim to a mass or product as a result of a security right in its components. Paragraph 1 is intended to ensure that a security right in a tangible asset that is commingled in a mass or transformed into a product will continue in the mass or product.

20. Paragraph 2 provides that a security right in a tangible asset that extends to a mass is limited to the same proportion of the mass that the asset bore to the quantity of the entire mass immediately after it was commingled in the mass. So, if a secured creditor has a security right in 100,000 litres of oil that is commingled with 50,000 litres of oil in the same tank so that the mass comprises 150,000 litres of oil, the security right is limited to two-thirds of the oil in the tank (i.e. 100,000 litres). If the quantity of the oil in the tank decreases, however, the secured creditor will still have security in two-thirds of the oil in the tank. For example, if one half of the oil leaks out so that only 75,000 litres remain, then the secured creditor will have a security right in two-thirds of those 75,000 litres, namely in 50,000 litres only. The value of the security right will decrease if the value of the oil in the tank goes down and correspondingly increase if the value of the oil in the tank goes up. This reflects commercial expectations, as it puts the secured creditor in the same position that the secured creditor would have been in if the oil had not been commingled in the tank with other oil in the first place.

21. Paragraph 3 applies a slightly different rule to products, consistent with the Secured Transactions Guide (see chap. II, para. 94). If the rule in paragraph 2 were to apply to security rights in assets that are transformed into a product, then this may provide the secured creditor with a windfall gain, if the value of the finished product is greater than the value of its components (e.g. because of value that is added by the debtor's production efforts including the labour of its employees). For this reason, paragraph 3 provides instead that a security right in an asset that is transformed into a product is limited to the value of the asset immediately before it

became part of the product. So, if encumbered flour worth €100 is mixed with yeast to make bread worth €500, the security right is limited to €100.

Article 12. Extinguishment of security rights

22. Under article 12, a security right is extinguished only where there is full payment or other satisfaction of all secured obligations and there is no longer any commitment of the secured creditor to extend further credit secured by the security right. For example, if a security right secures an amount owed under a revolving credit agreement, the security right is not extinguished where temporarily there is no amount outstanding under the credit agreement, since there may still be a contingent secured exposure under the commitment of the secured creditor to extend further credit.

23. The extinguishment of a security right triggers the obligation of a secured creditor in possession to return the encumbered asset or of a secured creditor that has registered a notice of its security right to register an amendment or cancellation notice (see art. 54 of the Model Law and art. 20, para. 3 (c), of the Model Registry Provisions).

B. Asset-specific rules

Article 13. Contractual limitations on the creation of security rights in receivables

24. Article 13 is based on recommendation 24 of the Secured Transactions Guide (see chap. II, paras. 106-110 and 113), which in turn is based on article 9 of the Assignment Convention. Paragraph 1 provides that an agreement limiting the grantor's right to create a security right in the receivables listed in paragraph 3 (often referred to as "trade receivables") does not prevent the grantor from creating a security right. The rationale underlying this approach is to facilitate the use of receivables as security for credit, which is in the interest of the economy as a whole, without unduly interfering with party autonomy. This rule does not affect statutory limitations on the creation or enforcement of a security right in certain types of receivable (e.g. consumer or sovereign receivables; see art. 1, paras. 5 and 6, and A/CN.9/914, paras. 29 and 30).

25. The agreement referred to in paragraph 1 may be entered into: (a) between the initial creditor/grantor and the debtor of the receivable (e.g. where the encumbered receivable is the claim of a seller for the outstanding balance of the purchase price, an agreement between the seller and the buyer); (b) where the initial creditor/grantor transfers the receivable to another person and that person creates a security right in the receivable, between that person (subsequent grantor) and the debtor of the receivable (e.g. where the seller sells the receivable to A and A creates a security right in favour of B, an agreement between A and the debtor of the receivable); (c) between the initial creditor/grantor and the initial secured creditor (e.g. an agreement between the seller and A); and (d) where the initial creditor/grantor transfers the receivable to a person and that person creates a security right, between that person (referred to in art. 13 as a subsequent grantor) and any secured creditor who obtained a security right from that person (referred to in art. 13 as a subsequent secured creditor; e.g. an agreement between A and B).

26. Paragraph 2 makes it clear that, while under paragraph 1 a security right is effective notwithstanding an agreement to the contrary, a person that creates a security right in a receivable in breach of that agreement is not excused from any liability to its counter-party for damages caused by breach of that contractual provision, if such liability exists under other law. Thus, for example, if the debtor of a receivable has sufficient negotiating power to convince the creditor of the receivable to consent to an anti-assignment agreement, and the creditor creates a security right in the receivable despite that agreement in a way that results in a loss to the debtor of the receivable, the creditor may be liable to the debtor of the

receivable for damages under the law of the State whose law governs that agreement. However, the debtor of the receivable may not avoid the contract because of that breach or raise against the secured creditor (including an outright transferee) by way of set off or otherwise any claim it may have against the grantor (including an outright transferor) for that breach. In addition, a secured creditor that accepts a receivable as security for credit is not liable to the debtor of the receivable for such a breach just because it had knowledge of the anti-assignment agreement. Otherwise, the anti-assignment agreement would in effect prevent a secured creditor from obtaining a security right in a receivable covered by the anti-assignment agreement.

27. One of the benefits of the rules in paragraphs 1 and 2 is that a secured creditor does not have to examine each contract from which a receivable might arise to determine whether it contains a contractual limitation on assignment that may affect the effectiveness of a security right. This facilitates transactions relating to pools of receivables that are not specifically identified (with respect to which a review of the underlying transactions is possible but not necessarily time- or cost-efficient), as well as transactions relating to future receivables (with respect to which such a review would not be possible at the time of the conclusion of the security agreement, with the result that future receivables could not be accepted by lenders as security for credit).

28. Paragraph 3 limits the scope of the rule in paragraph 1 to what could broadly be described as trade receivables. It does not apply to so-called "financial receivables", "because, where the debtor of the receivable is a financial institution, even partial invalidation of an anti-assignment agreement could affect obligations undertaken by the financial institution towards third parties. Such a result is likely to have negative effects on important financing transactions, such as those involving the assignment of receivables arising from or under securities or financial contracts" (see Secured Transactions Guide, chap. II, para. 108).

29. Article 13 (read together with art. 14) is intended to apply also to anti-assignment agreements limiting the creation of a security right in any personal or property rights securing or supporting payment or other performance of an encumbered intangible asset other than a receivable or an encumbered negotiable instrument.

Article 14. Personal or property rights securing or supporting payment or other performance of encumbered receivables or other intangible assets, or negotiable instruments

30. The first sentence of article 14 reflects the thrust of recommendation 25 of the Secured Transactions Guide (see chap. II, paras. 111-122), which in turn is based on article 10 of the Assignment Convention. It is intended to ensure that a secured creditor with a security right in the types of asset described in article 14 automatically has the benefit of any personal or property right that secures or supports payment or other performance of those types of asset. For example, a personal or property right that *secures* payment of a receivable may be an accessory or secondary guarantee (or suretyship) or a security right in immovable property; and a personal right that *supports* payment of a receivable may be an independent guarantee or a stand-by letter of credit. For example, if a receivable is secured by a personal guarantee or a security right in movable or immovable property, the secured creditor with a security right in that receivable obtains the benefit of that personal guarantee or security right. This means that, if the receivable is not paid, the secured creditor may seek payment from the guarantor or enforce the security right in accordance with the terms of the guarantee or the security right (which may require the secured creditor to register, if no registration was previously made, or make further registrations, if registration had already taken place; see para. 31 below).

31. The first sentence of article 14 does not include recommendation 25 (g) of the Secured Transactions Guide. This is because this matter is addressed in articles 57-58. Similarly, the first sentence of article 14 does not include recommendation 25 (h), of the Secured Transactions Guide (which was based on art. 10, para. 6, of the Assignment Convention). This is because it should be self-evident that the article does not apply to matters not addressed in it. Thus, to the extent that the automatic effects of the first sentence of article 14 are not impaired, any requirement under other law relating to the form or registration of the creation of a security right in any asset that is not covered in the Model Law (e.g. registration of an encumbrance on the relevant immovable property registry) is not affected.

32. The second sentence of article 14, which reflects the thrust of article 10, paragraph 1, of the Assignment Convention, is necessary because, in many States, some personal or property rights that might secure or support payment or other performance of a receivable or other intangible asset, or a negotiable instrument are transferable only with a new act of transfer. In such a case, the grantor is obliged to transfer the benefit of that right to the secured creditor. The reference in that sentence to the law governing the security or other supporting rights is intended to ensure that any other law that may require a new act of transfer is not overridden.

Article 15. Rights to payment of funds credited to a bank account

33. Article 15 is based on recommendation 26 of the Secured Transactions Guide (see chap. II, paras. 123-125). It is intended to implement the principles underlying article 13 with respect to rights to payment of funds credited to a bank account (see para. 30 above). As a result of article 15, a security right may be created in a right to payment of funds credited to a bank account even if there was an agreement between the grantor and the deposit-taking institution prohibiting the creation of a security right. However, as a result of article 69, the creation of such a security right does not affect the rights and obligations of the deposit-taking institution or obligate the deposit-taking institution to provide any information about the bank account to third parties.

Article 16. Negotiable documents and tangible assets covered by negotiable documents

34. Article 16 is based on recommendation 28 of the Secured Transactions Guide (see chap. II, para. 128). Its purpose is to follow existing law in which a negotiable document is treated as embodying rights in the tangible assets it covers. As a result, there is no need separately to create a security right in those tangible assets if there is a security right in the document (e.g. cargo covered by a negotiable document issued by the person in possession of tangible assets or agricultural products covered by a negotiable warehouse receipt issued by the operator of the warehouse in which those products have been deposited).

35. In view of the definition of the term “possession” in article 2, subparagraph (z), possession of tangible assets by the issuer of a negotiable document covering those assets includes possession by its representative or a person acting on behalf of the issuer (including in situations where the issuer is a carrier that uses other persons for the transportation of those assets on its behalf pursuant to a multi-modal transport contract). A security right in a negotiable document extends to the tangible assets covered by the document and will continue to exist (subject to the terms of the security agreement) even after the document no longer covers those assets. However, effectiveness against third parties through possession of the document applies only as long as the document covers the assets and lapses once they are released by the issuer (see art. 26, para. 2, and para. 49 below).

Article 17. Tangible assets with respect to which intellectual property is used

36. Article 17 is based on recommendation 243 of the Intellectual Property Supplement (see paras. 108-112). It is intended to recognize the distinction between

a tangible asset with respect to which intellectual property is used and the intellectual property used in connection with that asset. As a result, for a secured creditor to obtain a security right in both a tangible asset with respect to which intellectual property is used (e.g. a personal computer or television set) and the intellectual property itself, the security agreement would need to expressly provide for it.

Chapter III. Effectiveness of a security right against third parties

A. General rules

Article 18. Primary methods for achieving third-party effectiveness

37. Article 18 is based on recommendation 32 of the Secured Transactions Guide (see chap. III, paras. 19-86). It is intended to set out the primary methods for achieving third-party effectiveness of a security right. The first is registration of a notice of the security right in the Registry established under article 28. This method of third-party effectiveness is available for all types of movable asset to which the Model Law applies. The second is physical possession of the encumbered asset by the secured creditor (for the definition of the term "possession", see art. 2, subpara. (z)). As intangible assets may not be the subject of physical possession, this latter method is available only for tangible assets. Alternative methods of third-party effectiveness for security rights in rights to payment of funds credited to a bank account and in non-intermediated securities are set out in the asset-specific provisions of this chapter (see arts. 25 and 27 and paras. 47 and 51 below).

Article 19. Proceeds

38. Article 19 is based on recommendations 39 and 40 of the Secured Transactions Guide (see chap. III, paras. 87-96). It addresses the circumstances in which the security right in identifiable proceeds that is provided for in article 10 is effective against third parties.

39. Under paragraph 1, if a security right in an asset is effective against third parties, a security right in its identifiable proceeds in the form of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account is automatically effective against third parties, that is, without the need for any further act. For example, upon the sale of inventory that is subject to a security right that is effective against third parties, a security right in receivables arising from the sale of the inventory that are identifiable proceeds is effective against third parties without any further act. If those assets are described in the security agreement and the notice as original encumbered assets, article 18, which governs the third-party effectiveness of a security right in original encumbered assets, would apply, and not article 19 (this is the reason why, unlike rec. 39, on which this article is based, para. 1 does not refer to the description of the proceeds in the notice). If those assets are described in the security agreement as original encumbered assets but not in the notice, the security right in the proceeds would not be effective unless the conditions of paragraph 2 are satisfied.

40. For proceeds other than those covered in paragraph 1, paragraph 2 provides that, if a security right in an asset was effective against third parties, the security right in those types of proceeds (if they are identifiable) is effective against third parties for a short period of time that should be enough for the secured creditor to find out that proceeds have been generated and take action (such as 20-25 days); thereafter, the security right in the proceeds continues to be effective against third parties only if it is made effective against third parties before the expiry of that short time period by one of the methods set out in article 18 or the asset-specific provisions of this chapter. For example, if an encumbered motor vehicle with a

specific description is exchanged for another motor vehicle with a different description, the latter motor vehicle constitutes proceeds to which paragraph 2 applies; and the security right in the latter motor vehicle will cease to be effective against third parties if no registration is made prior to the expiry of the time period set out in paragraph 2.

Article 20. Tangible assets commingled in a mass or transformed into a product

41. Article 20 is based on recommendation 44 of the Secured Transactions Guide. Its purpose is to ensure that, if an asset is subject to a security right that is effective against third parties is commingled in a mass or transformed into a product, and the security right extends to the mass or product under article 11, the security right in the mass or product will be automatically effective against third parties. In other words, no separate act is necessary to make the security right in the mass or product effective against third parties (for the priority of this security right, see art. 42). It should be noted that preserving continuity of third-party effectiveness is relevant for the purposes of the priority rules.

Article 21. Changes in the method for achieving third-party effectiveness

42. Article 21 is based on recommendation 46 of the Secured Transactions Guide (see chap. III, paras. 120 and 121). It is intended to ensure that a security right that has been made effective by one method (e.g. registration) may later be made effective by another method (e.g. a control agreement), and that third-party effectiveness is continuous as long as there is no gap between the time third-party effectiveness was achieved by the first and the second method.

Article 22. Lapses in third-party effectiveness

43. Article 22 is based on recommendation 47 of the Secured Transactions Guide (see chap. III, paras. 122-127). It is intended to ensure that, if third-party effectiveness lapses, it may be re-established. In such a case, however, the third-party effectiveness dates only from the time it is re-established.

Article 23. Continuity in third-party effectiveness upon a change of the applicable law to this Law

44. Article 23 is based on recommendation 45 of the Secured Transactions Guide (see chap. III, paras. 117-119). Under paragraph 1, if the law enacting the Model Law becomes applicable as a result, for example, of a change in the location of the encumbered asset or the grantor, a security right that was effective against third parties under the previously applicable law continues to be effective against third parties under the law enacting the Model Law for a short period of time (such as 45-60 days) to give the secured creditor an opportunity to find out that the applicable law has changed and take action.

45. This rule does not apply if the third-party effectiveness of a security right under the initially applicable law has already lapsed or lapses during the short period of time set out in paragraph 1 (b) but before the security right is made effective against third parties. Thereafter, the security right continues to be effective against third parties only if, before the expiry of that period, it is made effective against third parties under the relevant provisions of the law enacting the Model Law. Under paragraph 2, if the third-party effectiveness of a security right continues (i.e. it did not lapse and the secured creditor satisfied the requirements for third-party effectiveness before the lapse and within the short period of time set out in para. 1 (b)), it dates back to the time it was first achieved under the previously applicable law. As already mentioned (see para. 43 above), if third-party effectiveness lapses, it may be re-established, but third-party effectiveness will then only date from the time it is re-established.

Article 24. Acquisition security rights in consumer goods

46. Article 24 is based on recommendation 179 of the Secured Transactions Guide (see chap. IX, paras. 125-128). An acquisition security right in consumer goods is automatically effective against third parties if the purchase price of the consumer goods is below an amount to be specified by the enacting State. While this limitation is intended to exempt from registration only low-value consumer transactions, for it to be meaningful, it must be set at a reasonably high price. That price should not be so high as to prevent a consumer from encumbering his or her assets to obtain credit, but not so low either to make it necessary for a secured creditor to register a notice of its security right in circumstances in which it would not be commercially practicable to do so. For example, the price could be several times the cost of registration to reflect the cost of typical durable household goods (for the question whether a buyer acquires its rights free of an acquisition security right that is automatically effective against third parties, see art. 34, para. 9).

B. Asset-specific rules

Article 25. Rights to payment of funds credited to a bank account

47. Article 25 is based on recommendation 49 of the Secured Transactions Guide (see chap. III, paras. 138-148). It adds to the general methods for achieving third-party effectiveness that are set out in article 18 three asset-specific methods of achieving the third-party effectiveness of a security right in a right to payment of funds credited to a bank account. First, if the secured creditor is the deposit-taking institution with which the account is held, no additional action is required for a security right to become effective against third parties. Second, the security right is effective against third parties upon conclusion of a control agreement among the grantor, the secured creditor and the deposit-taking institution (for the definition of the term “control agreement”, see art. 2, subpara. (g) (ii)). Third, the security right is effective against third parties if the secured creditor becomes the account holder. The precise action required for the secured creditor to become the account holder will depend on other factors, such as the law to which the deposit-taking institution is subject and the terms of the account agreement.

Article 26. Negotiable documents and tangible assets covered by negotiable documents

48. Article 26 is based on recommendations 51-53 of the Secured Transactions Guide (see chap. III, paras. 154-158). It addresses the relationship between the third-party effectiveness of a security right in a negotiable document and the third-party effectiveness of a security right in the tangible assets covered by the document.

49. Under paragraph 1, if a security right in a negotiable document is effective against third parties and extends to the assets covered by the document under article 16, the security right in the assets covered by the document will also be effective against third parties for as long as the assets are covered by the document. Under paragraph 2, the security right in the assets covered by the document can be made effective against third parties by possession of the document.

50. Under paragraph 3, a security right in an asset that is made effective against third parties by the secured creditor’s possession of the document remains effective against third parties for a short period of time (such as 10 days) even if possession of the document or the assets covered by the document is relinquished for the purpose of dealing with those assets. In paragraph 3, the words “or the asset covered by the document”, which did not appear in recommendation 53, were added for clarification as to what would happen in actual practice; and the words “physical actions like loading and unloading”, which appeared in that recommendation, were deleted on the understanding that the words “dealing with the asset” are sufficiently

broad to cover not only transactions like sale and exchange but also physical actions like loading and unloading.

Article 27. Uncertificated non-intermediated securities

51. Article 27 does not correspond to any of the recommendations of the Secured Transactions Guide, as the Guide did not apply to security rights in any type of securities (see rec. 4 (c)). It addresses the methods, other than registration of a notice, by which a security right in uncertificated non-intermediated securities may be made effective against third parties. First, the security right may be made effective against third parties by notation of the security right or entry of the name of the secured creditor as the holder of the securities in the books maintained by the issuer or by another person on behalf of the issuer for the purpose of recording the name of the holder of securities. The enacting State should choose the method that best fits its legal system; and if both methods are used in an enacting State, that State may choose to retain them both. Second, as in the case of a security right in a right to payment of funds credited to a bank account, the security right may be made effective against third parties through the conclusion of a control agreement between the grantor, the secured creditor and the issuer (for the definition of the term "control agreement", see art. 2, subpara. 2 (g) (i)).

Additional third-party effectiveness method for negotiable instruments and non-intermediated securities

52. Under article 19 of the Convention Providing a Uniform Law For Bills of Exchange and Promissory Notes (Geneva, 1930; the "Geneva Uniform Law"), "when an endorsement contains the statements 'value in security' ('valeur en garantie'), 'value in pledge' ('valeur en gage'), or any other statement implying a pledge, the holder may exercise all the rights arising out of the bill of exchange, but an endorsement by him has the effects only of an endorsement by an agent". Article 22 of the United Nations Convention on International Bills of Exchange and International Promissory Notes (the "Bills and Notes Convention") contains a similar rule, according to which "if an endorsement contains the words 'value in security', or any other words indicating a pledge, the endorsee is a holder who: (a) may exercise all rights arising out of the instrument …".

53. An enacting State that has enacted the Geneva Uniform Law (or the Bills and Notes Convention) may wish to include: (a) this rule in its enactment of the Model Law (as a rule of creation and/or third-party effectiveness of a security right in negotiable instruments and non-intermediated securities); and (b) a rule dealing with the comparative priority of such a security right. Another option would be to leave the matter to articles 46, paragraph 2, 49, paragraph 3, and 51, paragraph 5, under which such a holder of a negotiable instrument or a non-intermediated security would take its rights free of, or unaffected by, any security right. A further option would be to leave the matter to the relevant domestic law rule dealing with the hierarchy between domestic law and an international convention (see A/CN.9/914, para. 67).