United Nations A/CN.9/WG.VI/WP.79

General Assembly

Distr.: Limited
27 August 2018

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
Thirty-fourth session
Vienna, 17–21 December 2018

Draft Practice Guide to the UNCITRAL Model Law on Secured Transactions

Note by the Secretariat

Contents

V.18-05669 (E)

I. Introduction

A. Purpose of the Guide

What this Guide is about

1. This Guide aims to provide practical guidance to parties involved in secured transactions in States that have enacted the UNCITRAL Model Law on Secured Transactions (2016) (the "Model Law") by:

- Explaining key features and benefits of the Model Law;[1]
- Describing the types of secured transactions that creditors and other businesses can undertake under the Model Law; and
- Providing step-by-step explanations on how to engage in the most common and commercially important transactions.

Who this Guide is for

2. This Guide is intended to help those who are not familiar with the Model Law. It explains the operation of the Model Law in general and plain terms. Chapter II is written mainly for financiers and businesses engaged in or planning to engage in secured transactions and their advisers. It provides information on how to engage in several common types of secured transaction. Chapter III is intended primarily for regulated financial institutions and prudential regulatory authorities. This Guide will also be useful to other relevant stakeholders, such as policymakers and legislators of States considering the adoption of the Model Law, as well as judges and insolvency administrators.

B. Key benefits of the Model Law

What is a "security right"?

3. A "security right" is an interest in an asset that a person can exercise to recover money it is owed or to secure other obligations by another person (the "debtor"). A person with a security right (the "secured creditor") can protect itself when the debtor does not pay or perform the obligation by using the value of the asset (the "collateral" or the "encumbered asset") to recover what is owed. A secured creditor would generally have priority over "unsecured" creditors. In most cases, the debtor will be the person that grants the security right (the "grantor"), but this does not need to be the case — a person can also grant a security right to secure the obligations of another person.

A comprehensive and flexible secured transactions regime

4. A wide range of mechanisms have been developed to allow creditors to protect themselves against the risk of a debtor's default. However, many traditional legal systems only allow a person to grant a security right over its assets to a limited extent, or in a very restrictive way. Even where a legal system allows an asset to be used as security, the rules are often complex or unclear.

5. In contrast, the Model Law allows a person to give a security right over almost any type of movable asset to secure any type of debt or other obligation in almost any way. The Model Law covers all mechanisms under which a property right is created in a movable asset to serve a security function. In other words, the Model Law takes a "functional, integrated and comprehensive" approach — it applies to all rights in

[1] While the Practice Guide builds on the Model Law, it does not supplement the rules therein or suggest any changes to the provisions of the Model Law. [*Note to the Working Group: The Working Group may wish to consider whether this footnote which reflects para. 39 of* A/CN.9/932 *should be retained.*]

movable assets that are created by agreement and that secure the payment or performance of an obligation, regardless of the type of transaction or the terminology that the parties use. It also gives the parties a great deal of flexibility to structure their arrangements as they wish.

6. For example, the Model Law allows a person to grant a security right:

- Over almost any type of movable asset, including inventory, equipment, receivables, bank accounts, and all types of intellectual property;
- Over an asset that it already owns, as well as an asset that it may acquire in the future;
- Over all of its movable assets, both present and future;
- Without the need to give possession of the asset to the secured creditor; which extends to proceeds from a sale or any other dealing of the encumbered asset.

7. These transactions might not be possible in a State that has not adopted the Model Law and parties may not be aware of such possibilities even when a State has enacted the Model Law.

8. The Model Law also provides parties great flexibility in structuring how a security right can be enforced. A secured creditor has a number of options for enforcing its security right, and is not required to go to court (see Chapter II.H).

A simple and transparent system for registering security rights

9. Unlike some traditional secured transactions regimes where the registration of a security right is a requirement for its creation, a security right can be created under the Model Law and be effective against the grantor whether or not a notice is registered. However, a secured creditor will also want to make sure that its security right is effective against third parties as the security right will otherwise not be of much benefit. The most usual way to make a security right effective against third parties under the Model Law is to register a "notice" in the general security rights registry (the "Registry").[2]

10. The Registry provides a tool to make public the possible existence of a security right, thus making the security right effective against third parties. The Registry under the Model Law is fully electronic, accessible online and can be searched by anyone. Registrations are straightforward — a registrant needs to register a simple notice, and does not need to lodge the security agreement or any other documents. Registrations can be made at any time, even before the conclusion of the security agreement (on how to search and register, see Chapter II.C and E).

Why is greater access to credit a good thing?

11. The availability of credit has a significant impact on the economic prosperity of a State. If credit is readily available at a reasonable cost, it promotes the development and growth of businesses in that State, particularly small and medium-sized enterprises (SMEs). Considering that movable assets are the main type of collateral that SMEs can offer as collateral, a legal system that facilitates secured transactions using movable assets may enhances their ability to obtain credit at a lower interest rate.

[2] The Model Law includes Model Registry Provisions, a set of rules relating to the registry system. Depending on the drafting conventions, a State may incorporate the Model Registry Provisions in its secured transactions law, in a separate law or other legal instrument, or in a combination thereof. [*Note to the Working Group: The Working Group may wish to consider the need and if so, the placement of this footnote.*]

C. Secured transactions involving microenterprises: need for particular attention

12. The Model Law is designed to improve access to finance and to lower the cost of credit for all kinds of enterprises. As mentioned, it is particularly well suited for SMEs, which are the most common form of businesses in most States. Secured financing to microenterprises, however, requires particular attention because of some of their specific features, as outlined below.[3]

<Features of microenterprises>

- Small and informal — mostly individual entrepreneurs or family businesses
- Little distinction between the enterprise and its owners
- More likely to change legal status, name and address (particularly in the case of sole entrepreneurs)
- Insufficient or inappropriate assets to provide as security
- Less ability to provide lenders adequate financial information (either limited information, or information of poor quality)
- Weak bargaining power vis-à-vis lenders

<Features of financing to microenterprises>

- Loans of small amount and for a short period of time
- The overhead cost to the lender may not justify the small amount at stake
- Lenders are less likely to conduct an individual assessment of the loan application and of the assets offered as security
- Lenders are less likely to monitor assets provided as security
- Lenders often require personal guarantees in addition to a security right
- Enforcement of a security right may have direct impact on the personal finances of the owner and its family considering the close link with the enterprise's finances

13. When microenterprises need general financing (in contrast to financing for the acquisition of specific assets), the lack of assets to provide as security can be a major problem. The Model Law enhances access to finance for these enterprises by allowing any type of movable asset to be used as collateral, including all of their assets. The Model Law also enables security to be given over future assets, as well as circulating assets such as inventory, receivables and cash. This opens financing opportunities to microenterprises, since receipt of funds will be linked to future business activities, rather than to their scarce existing assets. The Registry helps lenders to be confident that they have priority over other claims, which reduces their risk and may eventually reduce the cost of credit.

14. Despite the benefits that the Model Law provides for microenterprises, lenders may need to tailor the ways in which they provide secured financing to microenterprises taking into account the specific features outlined above. These are discussed in the relevant parts of Chapter II.

[3] "Microfinance" is one method of financing to microenterprises, usually for a very short period and involving a small amount. Such type of financing, however, is usually "unsecured" and thus not addressed in this Guide.

D. Some things to bear in mind

The Guide is about secured lending using movable assets

15. This Guide addresses financing using movable assets as security. It does not address secured transactions that use immovable or real property as security. This Guide is also not a manual on lending practice in general. Guidance on good lending practices is provided only to the extent that they involve a secured transaction element.

The Guide does not address everything in the Model Law

16. The Model Law is a carefully constructed document. It relies on a number of specific and carefully worded definitions. For a range of policy reasons, there are also a number of qualifications and exceptions to the way in which some of its rules work. It is not possible for this Guide to cover all such circumstances as this Guide tries to explain the operation of the Model Law in a general and non-legal way. Some of the key terms that are used in the Model Law, or in this Guide, are explained in the Glossary (see **).

17. Readers should always rely on the precise language of the Model Law as enacted in their State and in the context of the State's laws as a whole, to understand exactly how the Model Law works in their State. Readers should also bear this in mind when considering the sample forms and templates.

The Model Law has options

18. Some provisions in the Model Law contain options. Where this is the case, this Guide explains how parties can deal with the various options to the extent possible. The readers will need to first determine which option has been adopted by their State in its enactment of the Model Law.

Other laws may also be relevant

19. The Model Law does not operate in a vacuum. Other laws, such as contract law, property law, intellectual property law, negotiable instruments law, consumer protection law, insolvency laws, and civil procedure law, will influence how the Model Law operates in that State. International treaties and conventions applicable in that State may also be relevant. Readers must consider all relevant legislation to understand the various possibilities and the consequences.

20. For example, under the laws of some States, lenders may be penalized if they take too much collateral (referred to as "overcollateralization").[4] In such circumstances, the lender may be obliged to release excess collateral back to the borrower, so that the borrower can use that collateral to obtain additional credit. In extreme cases, overcollateralization may jeopardize the enforceability of a security right and lenders should take due caution. [*Note to the Working Group: The Working Group may wish to consider whether the placement of para. 20 is appropriate (see A/CN.9/938, para. 43).*]

[4] See the UNCITRAL Legislative Guide on Secured Transactions (the "Secured Transactions Guide"), Chapter II, paras. 68–69.

II. How to engage in secured transactions under the Model Law

21. Chapter II of this Guide explains how a number of common or important types of secured transaction can be done under the Model Law. However, the examples provided are by no means the only types of transaction that are possible under the Model Law. For example, the Model Law also facilitates more complex secured financing arrangements, such as supply chain financing, value chain arrangements and securitization.

A. How to take an effective security right

1. Security over tangible asset(s) without taking possession

Example #1A: Company X has a printing business and wants to take a loan from Bank Y. Bank Y is willing to make the loan if it can take security over the printing press of Company X. However, Company X needs to keep possession of the printing press to continue to operate its business.

Step 1: Create a security right

22. To take a security right over the printing press, Bank Y needs to do two things:

- Make sure that Company X (the grantor) has sufficient property interest in the asset to grant a security right; and
- Have Company X create a security right over the asset in Bank Y's favour.

Does Company X have sufficient property interest?

23. In most cases, the grantor will be the owner of the asset. An owner would be able to create a security right over its assets. There may also be circumstances where a person may be able to grant a security right over an asset even though that person is not the owner but has a lesser interest in the asset (for example, if the person is leasing a car or has a license to a software).

Security provided by third parties

24. The grantor will usually be the borrower of the loan. Under the Model Law, that is not essential as it allows a person to grant a security right to secure an obligation owed by another person. For example, Company X may grant a security right over the printing press to secure a loan taken by Company Z. This is quite common, for example, where a bank provides financing to a group of companies (see example #6). In that case, each company in the group will often give security to secure the obligations of all other members of the group.

How does Company X create a security right?

25. Bank Y can take a security right over the printing press by entering into a security agreement with Company X. Under the Model Law, Bank Y does not need to take possession of the asset, and the printing press can stay in the possession of Company X allowing it to be used in Company X's operation. A creditor that has taken an effective security right over an asset becomes a secured creditor.

26. The security agreement needs to:

- Be concluded in or evidenced by a writing and signed by Company X;
- Identify the parties (Bank Y as the secured creditor and Company X as the grantor);
- Describe the obligation that is secured (the terms of the loan); and

- Describe the encumbered asset (the printing press) in a way that reasonably identifies it.

27. In some States, the security agreement would need to state the maximum amount for which Bank Y may enforce its security right.

Step 2: Make the security right effective against third parties

28. A security right created following step 1 will be effective against Company X. However, Bank Y will generally want to ensure that its security right is effective against third parties as well. Otherwise, Bank Y might not be fully protected if Company X becomes insolvent, or if Company X sells the printing press or grants a security right over it to somebody else.

29. Under the Model Law, the primary way in which Bank Y can make its security right effective against third parties is to register a notice in the Registry. In that way, third parties that search the Registry can be informed about the existence of Bank Y's security right (on how to register, see section E).

Example #1B: Company X has a delivery business with a small fleet of delivery vans. It wants to take a loan from Bank Y. Bank Y is willing to make the loan if it can take security over all the vans. Company X wants to retain possession of the vans so that it can continue to operate.

30. The Model Law allows a secured creditor to take security over more than one asset of the grantor at the same time. To do this, Bank Y simply needs to follow the above-mentioned steps. The only difference would be that Bank Y will need to ensure that the security agreement and the notice that it files with the Registry describe the encumbered asset broadly enough to cover all the vans, rather than just a single van.

2. Security over tangible assets, by taking possession

Example #2: X, an individual, wants to take a loan from Bank Y to start her own business. X does not yet have any business assets to offer as security but does own a number of antique rugs that she inherited. X keeps the rugs in a warehouse and does not intend use them. Bank Y is willing to make the loan if it can take security over the rugs.

31. In this example, Bank Y will need to:

- Make sure that X has a sufficient interest in the rugs to grant a security right;
- Have X create a security right in Bank Y's favour; and
- Ensure that its security right is effective against third parties.

32. The same steps taken in example #1A could be followed. Bank Y could enter into a written security agreement with X and register a notice in the Registry.

33. However, in this example, Bank Y could take possession of the rugs instead — either by having them delivered to its own warehouse, or by getting the warehouse to acknowledge that it now holds the rugs on behalf of Bank Y instead of X. If Bank Y takes possession of the rugs in this manner:

- A written security agreement signed by X would not be necessary; and
- Bank Y would not need to register a notice in the Registry to make its security right effective against third parties. [5]

[5] A security agreement does not need to be in writing where a secured creditor takes possession of the asset. A security right in a tangible asset is effective against third parties if the secured party is in possession of the assets.

34. Nonetheless, Bank Y may consider it prudent to request that X sign a written security agreement to reduce the risk that X might later dispute the terms of the agreement. Bank Y may also prefer to register a notice in the Registry in addition to taking possession, to avoid the adverse consequences that might follow if Bank Y were inadvertently to lose possession of the rugs.

3. Security over future assets

Example #3: Farmer X trades beef cattle. He wants to take a loan from Bank Y to purchase feed for his cattle. Bank Y is willing to make the loan if it can take security over his cattle, including cattle that Farmer X is planning to purchase, until the loan is repaid.

35. The Model Law allows a secured creditor to take security from a grantor over future assets in the same way as present assets and Bank Y would need to take the same steps required in example #1A. The only difference would be that Bank Y will need to describe the encumbered assets with a broadly inclusive term such as "all cattle, both present and future". The same description should be used in the registered notice. In such circumstances, Bank Y will immediately have a security right over the cattle owned by Farmer X when the security agreement becomes effective. With regard to the cattle acquired by Farmer X in the future, Bank Y will obtain a security right when Farmer X acquires them.

4. Security over all present and future assets (all-asset security)

Example #4: Company X organizes jungle safaris and wants to expand its offering to include white-water rafting expeditions. It wishes to take a loan from Bank Y to cover the expansion costs. Bank Y is willing to make the loan if it can take security over all assets of Company X's assets, including any future assets.

36. Taking a security right over all of grantor's existing and future assets is no more difficult than taking a security over a single existing asset. Bank Y would need to take the same steps required in example #1A. However, the security agreement should describe the asset being encumbered as "all movable assets, both present and future". The description in the registered notice could be the same or shortened to just "all movable assets".

37. By taking these steps, Bank Y will have a security right in all of Company X's equipment, inventory (for example, souvenir products it sells to customers), receivables, intangible assets (such as its intellectual property and goodwill), and any other movable asset that it owns or acquires in the future. Depending on the nature of Company X's major assets, Bank Y may wish to take additional steps to gain further protection for its security right (for example, if Company X's assets include securities held directly by it, see example #6; bank accounts, see example #7; negotiable instruments, see example #8; and intellectual property, see example #11).

38. If Company X defaults on its obligation to repay the loan, Bank Y can dispose of all the assets together so that the buyer acquires Company X's business in its entirety. Or it can dispose of the assets separately.

5. Financing the acquisition of tangible assets

Example #5A (Retention-of-title finance): Company X wants to purchase drilling equipment from Vendor Y. Rather than having Company X pay the price on delivery, Vendor Y is willing to give 30-day credit term to Company X. Vendor Y's terms of sale state that it retains title to the equipment until Company X has paid the purchase price in full.

Example #5B (Vendor purchase finance): Company X wants to purchase paint from Vendor Y. Rather than having Company X pay the price on delivery,

Vendor Y is prepared to give 30-day credit terms to Company X, as long as Company X gives Vendor Y security over the paint for the unpaid purchase price.

Example #5C (Purchase loan finance): Company X wants to purchase computers from Vendor Y. It wants to finance the purchase with a loan from Bank Z. Bank Z is willing to make the loan if it can take security over the computers. The proceeds of Bank Z's loan to Company X is used to pay Vendor Y.

Example #5D (Lease finance): Company X wants to purchase computers from Vendor Y. Vendor Y is keen for Company X's business, so rather than having Company X finance the purchase with a loan from Bank Z, Vendor Y agrees to lease the computers to Company X instead, for a three-year period. The rent under the lease is sufficient to cover Vendor Y's capital investment in the computers and its cost of funding the lease. At the end of the lease term, Company X can purchase title to the computers for a nominal sum.

39. Examples #5A to #5D are all situations in which the acquisition of tangible assets by Company X is financed by another entity.

40. In examples #5A and #5B, Vendor Y provides a short-term credit for the purchase. In example #5A, Vendor Y secures the unpaid purchase price as Company X does not become the owner of the drilling equipment until the purchase price is paid. This is a common security structure in many traditional legal systems. Taking a functional approach, the Model Law looks to the realities of the transaction and recognizes that the retention-of-title by Vendor Y is a security mechanism. For this reason, Vendor Y is treated in the Model Law as having only a security right over the drilling equipment. Company X is treated as the owner from the outset, and the retention-of-title sale agreement is treated as a security agreement. As long as the agreement describes the drilling equipment in a way that reasonably identifies it, is signed by Company X, and satisfies other requirements for a security agreement mentioned in example #1A, Vendor Y will have an effective security right over the drilling equipment. To make its security right effective against third parties, Vendor Y would need to register a notice describing the equipment.

41. In example #5B, Vendor Y is selling paint to Company X on short-term credit. This is in effect a short-term loan of the purchase price by Vendor Y. Vendor Y would need to follow the same steps as example #5A to take security over the paint.

42. In examples #5C and #5D, Company X is obtaining long-term financing to acquire the computers. Nonetheless, the Model Law applies in exactly the same way as in examples #5A and #5B. In example #5D, the transaction may be set up as a lease, but in effect, the lessor (Vendor Y) is using its ownership of the computers to secure Company X's obligation to pay the purchase price and other amounts owing to it under the lease — Company X pays the value of the asset over the term of the lease, and will undoubtedly exercise its right to become owner of the computers for a nominal sum at the end of the lease term. The Model Law is based on the functionality of the transaction rather than the language used by the parties, and thus it applies to the transaction in example #5D even though it is structured as a lease.

43. In other words, the lease agreement in example #5D is treated as a security agreement under the Model Law. As long as the agreement describes the computers in a way that reasonably identifies them, is signed by Company X, and satisfies other requirements for a security agreement mentioned in example #1A, Vendor Y is treated as a secured creditor and as having a security right over the computers.

44. In example #5D, the lease finance is provided by Vendor Y. However, lease finance can also be provided by banks and other financial institutions. Where that is the case, the financier will buy the computers from the vendor, and then lease them to Company X.

45. Under the Model Law, each of the security rights described in examples #5A to #5D qualify as an "acquisition security right". If the secured creditor (Vendor Y in examples #5A, #5B and #5D and Bank Z in example #5C) complies with article 38

of the Model Law, it will have super-priority or priority over non-acquisition secured creditors. This means that while a secured creditor that has registered a notice first usually has priority under the Model Law, an acquisition secured creditor may enjoy priority over those secured creditors that may have already registered a notice.

6. Security over company's shares (in the case of a corporate group)

Example #6: Mr. X operates a manufacturing business through a group of wholly-owned companies. He owns and directly holds all the shares of Company A, the holding company of the group. Company A in turn owns and directly holds all the shares of three subsidiaries, Companies B, C and D. Their shares are represented by certificates. Company A wants to take a loan to expand the operation of the group. Bank Y is willing to make the loan if it is secured over all assets of all companies in the group.

46. Bank Y will want to take a few steps to put the security arrangements in place for the financing. First, it may wish to take an all-asset security from Company A (including all its shares of Companies B, C and D) in the same manner as example #4. Secondly, it will want to take an all-assets security from Companies B, C and D in the same manner as example #4.[6] Thirdly, Bank Y may also want to take security over the shares of Mr. X in Company A. This would give Bank Y an important additional option upon enforcement, because it can then sell the corporate group in its entirety by selling the shares held by Mr. X and Company A. This is likely to be simpler, and to produce a better sales price than if Bank Y sold the group's assets separately.

47. Bank Y could make its security rights over all assets of Company A (including its shares) and shares of Mr. X by registering a notice in the Registry. As an alternative (or in addition), Bank Y could also make its security rights over the shares effective against third parties by taking possession of the certificates. Indeed, it would be to Bank Y's advantage to do so, as this would enable Bank Y to have priority over a competing security right made effective against third parties by registration.

48. In certain circumstances, shares in privately-held corporate groups may be issued without certificates. Where that is the case, Bank Y would not be able to take possession of the certificates. Instead, Bank Y could request that it be registered in the books of the issuer as the holder of the shares.[7] Alternatively, Bank Y could request that the issuer and the holder of the shares to enter into a control agreement with Bank Y, under which the issuer would agree to follow Bank Y's instructions with respect to the shares without requiring any further consent from the holder. Similar to taking possession of certificates, these options may ensure the priority of Bank Y's security right.

49. The Model Law applies to example #6 in that it applies to non-intermediated securities. The Model Law does not apply, however, to security rights in intermediated securities — that is, securities held through an intermediary or credited to a securities account. In such circumstance, Bank Y would need take into account other laws that provide a mechanism for taking security over intermediated securities.

7. Security over bank accounts

Example #7: Company X wants to take a loan to pay operating expenses. It has equipment that it can provide as collateral. Its only other asset is funds deposited in its bank account at Bank Y. Bank Z is willing to make a loan to cover the operating

[6] However, as those companies are not the borrower, Bank Y would usually require them to respectively give a guarantee of Company A's obligations (in some States, there may be limits on the extent to which a company can give guarantees and Bank Y should take this into account). That way, the security right granted by Companies B, C and D would secure the obligation of those companies under the guarantee.

[7] Depending on the rules applicable in the State, Bank Y may request its security right be notated in those books to make its security right effective against third-parties.

expenses on the basis of Company X's equipment. However, it also wants a security in the bank account to protect itself against the risk that the equipment might unexpectedly depreciate in value.

50. Bank Z can take a security right in the equipment of Company X and make it effective against third parties taking the same steps in example #1A. Taking a security right in the bank account is no more difficult. All Bank Z needs to do is describe the bank account in the security agreement. This could be done by stating in the security agreement (as well as the notice) the bank account number noting that the bank account was maintained by Bank Y. Alternatively, the security agreement could say "all bank accounts, both present and future". This could give Bank Z additional collateral if there were other bank accounts of which it was unaware at the time it made the loan.

51. In addition, if the bank account was being maintained by Bank Z instead of Bank Y, no additional step would be necessary to make the security right effective against third parties. Maintenance of the bank account is treated similar to a secured creditor's possession of tangible assets in example #2.

52. However, because the bank account in example #7 is being maintained by Bank Y, Bank Z could instead conclude a control agreement (a three-party agreement among Company X, Bank Y and Bank Z that Bank Y will follow the instructions of Bank Z with respect to the payment of funds without requiring any further consent from Company X). If Company X defaults, Bank Z may simply instruct Bank Y to transfer the funds directly to it. Bank Z may want additional protection in the control agreement. For example, if Company X is not likely to need access to all the funds in the account, the control agreement may require Bank Y to limit Company X's access to funds if withdrawing them would reduce the balance below an agreed level. If Bank Y is unwilling to agree to terms that Bank Z considers important, it can require Company X to move the account to Bank Z. No further steps would be necessary for the security right to be effective against third parties, and if desirable Bank Z can agree with Company X to limit its right to withdraw funds from the account.

53. If Bank Z took a security interest in all of Company X's present and future bank accounts, it cannot practically obtain a control agreement with banks maintaining accounts that it does not know about. This means that Bank Z's security right in those unknown accounts can only be made effective against third parties by registration. Furthermore, Bank Z will not be in a position to order a maintaining bank to forward funds to it when Company X defaults and Bank Z later discovers the existence of an account. In many jurisdictions, this will require a court order.

8. Security over negotiable instruments

Example #8: Company X is owed a large sum of money by Company Y. Company Y signed a negotiable instrument promising to pay the money to Company X in instalments over a five-year period. Company X wants to take a loan to pay operating expenses and would like to use its right to collect from Company Y under the instrument as security. Bank Z is willing to make the loan on that basis.

54. For Bank Z to be certain that its security right in the negotiable instrument is effective, it should follow the steps in example #1A and the security agreement must properly describe the negotiable instrument. The description could be something like "a negotiable instrument signed by Company Y on DD/MM/YYYY, payable to Company X, in the amount of (the face amount stated in the instrument)". If Bank Z were taking a security right over all of the existing and after-acquired negotiable instruments of Company X, as might be the case if Company X regularly generated negotiable instruments in the course of its business, the description could be "all negotiable instruments, both present and future".

55. To make its security right effective against third parties, Bank Z can register a notice describing the negotiable instrument or as with other tangible assets, take

possession of the instrument (see example #2). There are in fact distinct advantages to the latter option. If Bank Z merely registers and does not take possession, its security right will lose to another secured creditor if that secured creditor takes possession of the negotiable instrument. Bank Z might also lose to a buyer of the instrument that obtained possession of the negotiable instrument under certain circumstances (for example, if the buyer did not know about Bank Z's security right).

9. Sale or outright transfer of receivables

Example #9 (Factoring): Company X is in the business of selling inventory to customers. Because the inventory is expensive, customers frequently agree to pay over time (without using negotiable instruments). This creates a pool of receivables which constitutes Company X's most valuable asset. Company X needs cash before the receivables are due so that it can pay its employees and other operating expenses. Factor Y agrees to provide Company X with cash by purchasing the receivables it deems to be creditworthy. Factor Y advances to Company X an amount equal to 90 per cent of the face value of those receivables, holding the remaining 10 per cent as a reserve to cover potential customer claims (such as for defective goods or supplying the wrong goods) that could reduce the value of the receivables.

56. The Model Law applies to a sale of receivables, which is referred to as an outright transfer by agreement. One reason for this approach is that it is often difficult to tell whether a receivable is being sold or being transferred as security. Applying the provisions of the Model Law to all transfers of receivables reduces the need to make at times the difficult distinction.

57. Because the Model Law applies to outright transfers of receivables, the transferor (or the assignor) is treated as a grantor and the transferee (or the assignee) is treated as a secured creditor. Thus, in example #9, Factor Y will need a sale agreement signed by Company X describing the receivables being sold. A key practical consequence of this approach is that the transferee would need to register a notice in the Registry to make the transfer effective against third parties. Unless Factor Y registers a notice in the Registry, its right to the receivables could be defeated by a third party with a competing interest in them.

58. There are a number of different types of factoring arrangements involving outright transfers of receivables. Factor Y may pay the price for the receivables at the time of the purchase ("discount factoring"), as is the case in example #9. Factor Y might pay only when the receivables are collected ("collection factoring"), or it might pay on the average maturity date of all of the receivables ("maturity factoring"). Factoring can be on a "recourse" or "non-recourse" basis.[8] Factoring can also be on a "notification" or "non-notification" basis.[9]

59. Factoring is generally used by a supplier by transferring receivables against several debtors. A reverse factoring arrangement, initiated by the debtor of the receivable, uses factoring for the payment of incoming invoices and the factor undertakes to purchase receivables from various suppliers of the debtor.

60. Although the Model Law applies generally to the outright transfer of receivables, enforcement-related provisions are generally not applicable. For example, in a non-recourse arrangement, the factor's collection efforts do not need to be commercially reasonable. That is because the factor owns the receivable, and if it collects less than the full amount the loss will fall on the factor. Also, the factor does

[8] Under a recourse factoring arrangement, Factor Y has recourse against Company X if the debtor of the receivable fails to make payment. Under a non-recourse factoring arrangement, Factor Y takes the risk that the debtor of the receivable might not pay on time.

[9] Notification factoring occurs when the debtors of the receivables are notified that their receivables have been transferred and are instructed to make payment directly to Factor Y. Non-notification means that the debtors of the receivables are not notified of the transfer and will continue to pay Company X.

not need to account to the transferor of the receivable for any amount collected in excess of the amount the factor paid for it.

10. Inventory and receivables financing

Example #10 (Revolving loan): Company X sells kitchen appliances to restaurant owners. Many of its sales are on credit, with the customers paying for the appliance over a period of time. Company X needs operating funds from time to time to pay its ordinary expenses. Bank Y is prepared to advance funds by setting up a line of credit that Company X can draw on when it needs funds, as long as Bank Y is given security over all of Company X's existing and future inventory and receivables, and collections on the receivables are used to pay down the line of credit. Bank Y also wants security over the bank account into which Company X deposits payments it receives from its customers.

61. Taking security rights in all existing and future inventory and receivables require the same steps as mentioned in example #1A. Bank Y simply needs to describe the asset properly in the security agreement (for example, "all inventory and receivables, both present and future", and register a notice that states for example, "all inventory and receivables"). To take an effective security right over the bank account, steps set out in example #7 need to be followed.

62. Company X's business is cyclical in nature. It needs capital to acquire inventory and because many of its sales are on credit, it needs capital before it is paid for the inventory that it has made and sold. Because of this business cycle, Bank Y provides Company X with a line of credit (often called a revolving loan), under which Company X can draw down a loan when it needs working capital to buy inventory or pay other expenses, and which is then repaid as the receivables are collected. It is likely that borrowings and repayments will be frequent and that the outstanding amount due will constantly fluctuate. The pool of encumbered inventory and receivables will also fluctuate as inventory is acquired and converted into receivables, the receivables are collected, and new inventory is acquired. The line of credit structure matches Company X's borrowings to it business cycle and helps Company X avoid borrowing more than it needs, minimizing its interest costs.

11. Security over intellectual property

Example #11: Company X is a pharmaceutical company. It has patents on the drugs that it markets, and a number of pending patent applications on drugs under development. Company X would like to raise loan capital to fund R&D expenses. Bank Y is willing to provide the loan if it can take security over Company X's patents and patent applications.

63. The Model Law applies to security rights in intellectual property as long as the provisions therein are not inconsistent with the law relating to intellectual property. The following analysis is based on the assumption that there is nothing in the Model Law that is inconsistent with the law governing patents.

64. Bank Y could create a security right over the patents and patent applications and achieve effectiveness against third-parties by following the steps mentioned in example #1A. For example, Bank Y could describe the encumbered assets as "all patents and patent applications, both present and future" in the security agreement and the registered notice. However, if the law governing patents require that effectiveness against third parties can only be accomplished by registering in the specialized patent registry, Bank Y would need to take such measure.

12. Security over proceeds

Example #12: Company X took a loan from Bank Y and granted a security right over its printing press. Company X kept possession of the printing press to operate its business and later sold the press to Company Z.

65. Under the Model Law, a security right in an asset extends to its identifiable proceeds. In example #12, even though Company X sold its printing press, Bank Y's security right would extend to the money received by Company X from Company Z or any new asset purchased with that money. If the equipment was damaged or destroyed due to a fire, Bank Y's security right would extend to any related insurance claims by Company X. In short, Bank Y's security right extends to any asset in any form that can be identified as derived from the original asset or its proceeds.

66. If Bank Y's security right in the printing press had been made effective against third parties, and if the proceeds received by Company X are in the form of money, receivables, negotiable instruments or funds in a bank account, Bank Y does not need to do anything more to make its security right in the proceeds effective against third parties. However, if the proceeds are another type of asset (for example, if the printing press was exchanged with a computer), Bank Y must make its security right in the computer effective against third parties before the expiry of the prescribed grace period.

67. Bank Y would not need to do anything to make its security right in the computer effective against third parties if the description of the original encumbered asset in the security agreement as well as in the registered notice already included the proceeds (for example, the computer purchased by Company X) or was sufficiently broad (for example, "all present and future movable assets").