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Security interests

Draft legislative guide on secured transactions

Note by the Secretariat

Addendum

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XIV. Transition

A. General remarks

1. The need for transition provisions

1. The rules embodied in new secured transactions legislation may be different from the rules in the law predating the legislation. Those differences will have an obvious impact on secured transactions that will be concluded after the new legislation is enacted. In light of the differences between the old and new legal regimes and the continued existence of transactions and security rights created under the old regime, it is important for the success of the new legislation that it contains fair and efficient rules governing the transition from the old rules to the new rules. A similar need for transition rules is present when, under the private international law rules of the old regime, the law of a different State governed the creation, effectiveness against third parties or priority of a security right.

2. Two issues related to the transition from the old regime to the new law must be addressed. First, the new legislation should provide the date as of which it will have legal effect (the “effective date”; see A/CN.9/631, recommendation 223). Second, the new legislation should also set forth the extent, if any, to which, after the effective date, the new legislation applies to issues relating to transactions or security rights that existed before the effective date.

3. A number of factors require consideration in determining the effective date of the legislation. Prompt realization of the economic advantages of new legislation must be balanced against the need to avoid causing instability in, or disruption of, the markets that will be governed by new legislation and in allowing the market participants adequate time to prepare for conducting transactions under the new legislation, which may be significantly different from the prior law. Accordingly, a State may conclude that the effective date of new legislation should be some period of time after the enactment of the new legislation in order for these markets and their participants to adjust their transactions to the new rules. In determining the effective date, States might consider: the impact of the effective date on credit decisions; maximization of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonization of the new secured transaction legislation with other legislation; constitutional limits to the retroactive effect of new legislation; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

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

5. One approach 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 might be some appeal in such a solution, especially with respect to issues that arise between the grantor and the secured creditor, such an approach would create significant problems, especially with respect to priority issues. Foremost among those problems would be the necessity of resolving priority disputes between a secured creditor that obtained its security right prior to the effective date and a competing secured creditor that obtained its security right in the same property after the effective date. Because priority is a comparative concept, and the same priority rule must govern the two rights that are being compared, it is not possible for the old rules to govern the priority of the right of the pre-effective-date creditor and the new rules to govern the priority of the right of the post-effective-date creditor. Of course, determining which priority rule to apply to such priority disputes is not without difficulty. Applying the old rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new legislation, with the result that significant economic benefits of the new legislation could be deferred for a substantial period. On the other hand, applying the new rules to such priority disputes might unfairly prejudice parties that relied on the old law and might also provide an incentive for such parties to object to the new legislation or advocate an unduly delayed effective date.

6. Alternatively, greater certainty and earlier realization of the economic benefits of the new legislation could be promoted by applying the new legislation to all transactions as of the effective date, but with such “transition provisions” as are necessary to assure an effective transition to the new regime without loss of pre-effective-date priority status. Such an approach would avoid the problems identified above and would otherwise fairly and efficiently balance the interests of parties that complied with the old law with the interests of parties that comply with the new law.

2. Issues to be addressed by transition provisions

(a) Generally

7. Because many security rights created before the effective date will continue to exist after the effective date and may come into conflict with security rights created after the effective date, it is important for the new legislation to provide clear transition provisions to determine the extent to which the rules in the new legislation will apply to those pre-existing rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction creating a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between a holder of a security right and a competing claimant, when either the security right or the right of the competing claimant was created before the effective date.

(b) Disputes before a court or arbitral tribunal

8. When a dispute is in litigation (or a comparable dispute resolution system, such as arbitration) at the effective date, 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 (see A/CN.9/631, recommendation 224).

(c) Effectiveness of pre-effective-date rights as between the parties

9. 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 grantor and the creditor. The first question is whether a security right that was not effectively created under old law but fulfils all the requirements for creation of a security right under the new law should become effective on the effective date of the new law. The second question is whether a security right that was effectively created under the old law but does not fulfil the requirements for creation under the new law should become ineffective on the effective date of the new law.

10. With respect to the first question, consideration should be given to making the right effective as of the effective date of the new law, since the parties presumably favoured effectiveness. With respect to the second question, a transition period might be created during which the security right would remain effective between the parties, so that the creditor could take the necessary steps for creation under the new law during the transition period. At the expiration of the transition period, if such steps had not been taken the right would become ineffective under the new law. On the other hand, a simpler approach would be to have all issues of the effectiveness between the parties of a security right created before the effective date governed by the rules in effect at that time (see A/CN.9/631, recommendation 225).

(d) Effectiveness of pre-effective-date rights as against third parties

11. Different issues arise as to the effectiveness against third parties of a right created before the effective date. As the 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 of the enacting State (or under the law of the State whose law applied to third-party effectiveness under the private international law rules of the old regime) to comply immediately with any additional requirements of the new law. The expectation would be especially onerous for institutional creditors, which would be required to comply with the additional requirements of the new law simultaneously for large numbers of pre-effective-date transactions.

12. A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules to remain effective for a reasonable period of time (as set forth in the new law) so as to give the creditor time to take the necessary steps under the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law (see A/CN.9/631, recommendation 226).

13. 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. Once again, the presumption is that the parties intended effectiveness as between them, and third parties are protected to the full extent of the new rules.

(e) Priority disputes

14. An entirely different set of questions arises in the case of priority disputes because such disputes necessarily involve applying one set of rules to two (or more) different rights created at different times. A legal system cannot simply provide that the priority rule in effect at the time when a security right was created governs priority with respect to that right because such a rule would not provide a coherent answer when one of the rights that is being compared was created under the former regime while the other was created under the new regime. Rather, there must be rules that address each of the following situations: (a) where both rights are created after the effective date of the new legislation; (b) where both rights are created before the effective date; and (c) where one right is created before the effective date and the other right is created after the effective date.

15. The easiest situation is a priority dispute between two rights that were created after the effective date of the new legislation. In that situation, it is obvious that the priority rules in the new legislation should be applied to resolve that dispute.

16. Conversely, if both of the competing rights were created before the effective date of the new legislation (and, accordingly, the relative priority of the two competing rights in the encumbered assets was established before the effective date of the new rules) and, in addition, nothing (other than the effective date having occurred) has happened that would change that relative priority, stability of relationships suggests that the priority established before the effective date should not be changed. If, however, something occurs after the effective date that would have had an effect on priority even under the previous legal regime (such as a security right becoming effective against third parties or ceasing to be effective against third parties), there is less reason to continue to utilize old rules to govern a dispute that has been changed by an action that took place after the effective date. Therefore, there is a much stronger argument for applying the new rules to such a situation (see A/CN.9/631, recommendations 228-230).

17. The most difficult transition situation involves a priority dispute between one right that was established before the effective date and another right that was established after the effective date. In such a case, while it is preferable to have the new rules govern eventually, it is 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. If those steps are taken within the requisite time, the new legislation should 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 (see A/CN.9/631, recommendations 227 and 229).

B. Recommendations

[Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.]