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Draft legislative guide on secured transactions

Note by the Secretariat*

Addendum

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X. Post-default rights

A. General remarks

1. Introduction

1. Parties to any agreement usually expect each other voluntarily to perform all their obligations, whether owed between themselves or to third parties, and whether these obligations arise by contract or by operation of law. Only where performance is not forthcoming do parties contemplate compulsory enforcement through a judicial procedure. Typically, States carefully develop enforcement regimes for ordinary civil actions that balance the rights of debtors, creditors and third parties. In most States these regimes require a creditor seeking to enforce performance to bring a court action to have the claim recognized and then to have the debtor's property seized and sold under the supervision of a public official. From the amount generated by the sale, the judgement creditor will receive payment of its outstanding claim against the judgement debtor.

2. Parties to a security agreement have similar expectations of each other. A secured creditor usually presumes that a grantor will perform its obligations voluntarily. Likewise, a grantor will typically expect the secured creditor to fulfil the obligations it has undertaken. Both enter the transaction fully expecting and intending to meet their obligations to each other. Yet both also recognize that there will be times when they may not be able to do so. Sometimes the secured creditor will fail to make a promised payment, or to return property to a grantor when an agreed condition for doing so occurs. In such cases, depending on the nature of the agreement between them, the grantor will normally apply to the court for relief. Most often, however, it is the grantor that finds itself incapable of performing as promised (that is, will not repay the credit according to the terms of the agreement). The failure will sometimes flow from reasons beyond the grantor's control, such as an economic downturn in an industry or more general economic conditions. Sometimes it may result from defaults by the grantor's own debtors. Sometimes the grantor cannot perform owing to business misjudgements, or as a consequence of poor management.

3. Whatever the reason, even after one or more payments have been missed, it is in the interest of both parties to a security agreement, and to third parties generally, that the grantor attempt to make up these payments and continue voluntarily to perform the promised obligation. Compulsory enforcement proceedings are always less efficient than voluntary performance, since (a) they are costly; (b) they take time; (c) the outcome is not always certain; and (d) the longer-term consequences for grantors and third parties are often devastating. This is why many States actively encourage parties to a security agreement to take steps during its currency to avoid a failure of performance that would lead to compulsory enforcement. Moreover, this is why secured creditors often will closely monitor their grantors' business activities. For example, they will periodically review account books, inspect the encumbered assets and communicate with those grantors that show signs of financial difficulty. Grantors having trouble meeting their obligations generally will cooperate with their secured creditors to work out ways to forestall or to overcome their difficulties. In some cases, a grantor may request a secured creditor's assistance in developing a new business plan. In other cases, the grantor and an

individual creditor, or the grantor and its whole group of creditors working together, may attempt to readjust aspects of their agreements.

4. There are many types of debt readjustment agreements. Sometimes the parties enter into a "composition" or "work-out" arrangement that extends the time for payment, otherwise modifies the grantor's obligation, or adds or reduces encumbered assets that secure these obligations. Negotiations to reach a composition agreement take place against a background of two main factors: (a) the secured creditor's right to enforce its security rights in the encumbered assets if the grantor defaults on its secured obligation; and (b) the possibility that insolvency proceedings will be initiated by or against the grantor.

5. Nevertheless, despite the best efforts of grantors and secured creditors to avoid compulsory enforcement proceedings, they will occasionally be unavoidable. One of the key issues for States enacting secured transactions regimes is, consequently, to decide the contours of a creditor's post-default rights. More specifically, the question is what modifications, if any, States should make to the normal rules that apply to the enforcement of claims when developing rules to govern how security rights can be enforced when the grantor fails to perform the secured obligation.

6. At the heart of a secured transactions regime is the right of the secured creditor to look to the amount that can be realized upon the sale of the encumbered assets to satisfy the secured obligation. Enforcement mechanisms that allow creditors accurately to predict the time and cost involved in disposing of the encumbered assets and the likely proceeds received from the enforcement process will have a significant impact on the availability and the cost of credit. A secured transactions regime should, therefore, provide efficient, economical and predictable procedural and substantive rules for the enforcement of a security right after a grantor has defaulted. At the same time, because enforcement will directly affect the rights of third parties, the rules should provide reasonable safeguards for the rights of the grantor, other persons with a right in the encumbered assets and the grantor's other creditors.

7. All interested parties benefit from maximizing the amount achieved from the sale of the encumbered assets. The secured creditor benefits by the potential reduction of any deficiency that the grantor may owe as an unsecured obligation after application of the proceeds of enforcement to the outstanding secured obligation. At the same time, the grantor and the grantor's other creditors benefit from a smaller deficiency or a larger surplus.

8. This chapter examines the secured creditor's right to enforce its security right if the grantor fails to perform ("defaults on") the secured obligation prior to the institution of insolvency proceedings or, with the permission of the appropriate body, during insolvency (see chapter XI). In section A.2 of the chapter, the general principles guiding default and enforcement are discussed. Section A.3 reviews the procedural steps that a secured creditor may be required to follow prior to exercising its remedies and sets out the grantor's post-default rights. The different recourses typically available to secured creditors are examined in section A.4. In section A.5 the effects of enforcement on the grantor, the secured creditor and third parties are considered.

9. The enforcement of security rights in receivables, negotiable instruments, funds credited to a bank account and proceeds under an independent undertaking

does not fit easily into the general procedures for enforcement against tangible property (for the definitions of those terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). As a result, many States have particular rules dealing with enforcement against intangible property, receivables and various other rights to payment. These special situations are discussed in sections B.1-B.5 of this chapter. In addition, because tangible property may sometimes be attached to other movable or immovable property, or may be commingled or manufactured, it is necessary to adjust the general regime to govern enforcement of attachments and masses or products. The types of adjustment that may be necessary for effective enforcement against attachments, masses or products are discussed in sections B.6-B.9. The chapter concludes, in section C, with a series of recommendations.

2. General principles of enforcement

(a) General

10. As noted in the preceding section, it is in everyone's interest that the grantor voluntarily performs its promised obligation. For this reason, when performance is not forthcoming, the secured creditor and the grantor normally will attempt to conclude an agreement that obviates the need to commence compulsory enforcement proceedings. Seldom will a grantor be unaware that it is not performing its obligations and even more rarely, if ever, will the grantor learn for the first time that it is in default by means of a formal indication to this effect from the secured creditor. Indeed, in the latter case, enforcement proceedings usually do not follow since the failure of performance will almost always have been due to inadvertence rather than an inability or unwillingness to pay. Still, compulsory enforcement will sometimes become necessary. When it does, a number of basic principles guide States in elaborating the post-default rights and obligations of secured creditors and grantors.

(b) Requirement of a default prior to enforcement

11. A security right secures the performance of a grantor's (or, in the case of a third-party grantor, the debtor's) obligation to the secured creditor. In the standard case, therefore, the security right becomes enforceable as soon as the grantor fails to pay the secured obligation. There are, however, a number of other "events of default" that are typically set out in the security agreement. Any one of these events, unless waived by the secured creditor, is sufficient to constitute a default, thereby permitting compulsory enforcement of the security right. In other words, the parties' agreement and the general law of obligations will determine whether the grantor is in default and when enforcement proceedings may be commenced. This general law of obligations usually will also determine whether a formal notice of default must be given to the debtor and, if so, what the content of that notice will be.

12. Occasionally, default occurs not because a payment has been missed, but because another creditor either seizes the encumbered assets under a judgement or seeks to enforce its own security right. Many States provide that, apart from any stipulation in the security agreement, the seizure of encumbered assets by any other creditor constitutes a default under all security agreements that encumber the seized property. The rationale is based on efficiency. Since the encumbered asset is the creditor's guarantee of payment, whenever that asset is subject to judicial process,

the secured creditor should be enabled to intervene to protect its rights. In these cases, procedural law will often give these other creditors the right to force the disposition of encumbered assets. The secured creditor will look to this same procedural law for rules on intervening in these judicial actions and enforcement proceedings in order to protect its rights and its priority.

13. Typically, States provide that a secured creditor with priority will be able to substitute its own enforcement process for that of a subordinate secured creditor should it so choose. This rule follows because the two secured creditors will be enforcing similar rights under the same security regime and the enforcement rights of these creditors should, therefore, be determined by their respective priority. By contrast, in some States, once enforcement of a judgement claim has commenced, the secured creditor may not intervene to enforce its rights under the security agreement. This approach is usually followed in States where a judicial sale purges all rights, including security rights, from the property sold. The assumption is that because the judicial sale enables the purchaser to acquire a clean title, it will produce the highest enforcement value (see paras. 20-23 below). In other States, however, where a secured creditor has rights in some or all of the property under seizure by a judgement creditor, the secured creditor is permitted to raise the seizure and enforce its security rights by any means available to it. This approach is usually found in States where a regular judicial sale in execution does not purge security rights. The assumption is that since security rights will not be purged, a higher price of disposition is more likely to be realized when the enforcement process leads to the purchaser obtaining the cleanest title (see paras. 61 and 62 below).

(c) Judicial supervision of enforcement

14. Generally speaking, when a grantor is in default and attempts to compose the obligations have failed, both parties are reconciled to the need for compulsory enforcement against the encumbered assets. In some cases, however, grantors will contest either the secured creditor's claim that they are in default, or the secured creditor's calculation of the amount owed as a result of the default. As a matter of public policy, States invariably provide that grantors are always entitled to request courts to confirm, reject, modify or otherwise control the exercise of a creditor's enforcement rights.

15. The point is not to burden secured creditors with unnecessary judicial procedures, but rather to enable grantors and other interested parties to ensure respect for mandatory post-default procedures (see A/CN.9/631, recommendation 141). Consequently, to ensure that grantor challenges to enforcement can be dealt with in a time- and cost-efficient manner, many States replace the normal rules of civil procedure with expedited judicial proceedings in these cases (see A/CN.9/631, recommendation 137). For example, grantors and other interested parties may be given only a limited time within which to make a claim or raise a defence. Other States permit grantors to challenge the secured creditor on these issues even after enforcement has commenced, or at the time proceeds of enforcement are distributed, or when the secured creditor seeks to collect any deficiency. Still other States permit grantors to obtain not only compensatory damages, but also punitive damages, should it be shown that the secured creditor either had no right to enforce, or enforced for an amount greater than that actually owed.

16. Furthermore, because all such challenges will delay enforcement and add to its cost, many States also build safeguards into the process to discourage grantors from making unfounded claims. These include procedural mechanisms, such as adding the costs of the proceedings to the secured obligation in the event that they are unsuccessful, or requiring affidavits from grantors and their counsel as a prerequisite to launching such proceedings. Some States also permit secured creditors to seek damages against grantors that bring frivolous proceedings, or fail to comply with their obligations, and to add these damages to the secured obligation. This Guide recommends that ordinary damages be available if the grantor fails to comply with any of its post-default obligations (see A/CN.9/631, recommendation 133; the same rule applies to the secured creditor).

(d) Good faith and commercial reasonableness

17. Enforcement of a security right has serious consequences for grantors, debtors and interested third parties. For this reason, many States impose, as a general and overriding obligation of secured creditors, a specific duty to act in good faith and follow commercially reasonable standards when enforcing their rights. Because of the importance of this obligation, these States also provide that at no time may the secured creditor and the grantor waive or vary it (see A/CN.9/631, recommendations 128 and 129). Moreover, as noted, a secured creditor that does not comply with enforcement obligations imposed on it will be liable for any damages caused to the persons injured by its failure. For example, if a secured creditor does not act in a commercially reasonable manner in disposing of the encumbered assets and that results in the secured creditor obtaining a smaller amount than a commercially reasonable disposition would have produced, the secured creditor will owe damages to any person harmed by that differential (see A/CN.9/631, recommendation 133).

(e) Freedom of parties to agree to the enforcement procedure

18. States generally impose very few pre-default obligations on parties to a security agreement (see chapter VIII, Rights and obligations of the parties). A key issue in the post-default enforcement context is, consequently, whether a similar policy should prevail. In other words, the issue is to what extent the secured creditor and the grantor should be permitted to modify either the statutory framework for enforcing security rights or their respective contractual rights as set out in the security agreement. Some States consider the enforcement procedure to be part of mandatory law that the parties cannot modify by agreement. In other States, the parties are allowed to modify the statutory framework for enforcement as long as public policy, priority, and third-party rights (in particular in the case of insolvency) are not affected. In yet other States, emphasis is placed on efficient enforcement mechanisms in which judicial enforcement is not the exclusive or the primary procedure. Hence, even if there are limits on the extent to which the secured creditor and the grantor may agree to modify the statutory framework in their security agreement (because the freedom to vary an enforcement obligation may be the subject of abuse at the time of conclusion of the security agreement), these States permit them to waive or modify their rights under the security agreement after a default occurs.

19. States that permit parties to waive their legal or contractual post-default rights by agreement nonetheless impose a number of restrictions on their capacity to do so. For example, they invariably do not permit waiver of the creditor's obligation to act in good faith and in a reasonably commercial manner (see A/CN.9/631, recommendation 129). As for other obligations, many States distinguish between the rights of the grantor and those of the secured creditor. In some States, the grantor may waive or agree to vary the secured creditor's post-default obligations only after a default has occurred. Allowing a waiver after default often enables the grantor and the secured creditor to "work out" in a non-adversarial way a disposition of the encumbered assets in a manner that maximizes the amount that can be realized for the benefit of the secured creditor, the grantor and the other creditors of the grantor (see A/CN.9/631, recommendation 130). These same States usually also permit a secured creditor to waive a grantor's obligations at any time (either prior to or after default) on the assumption that there is little risk of abusive terms being imposed by the grantor at the time the credit is being extended (see A/CN.9/631, recommendation 131).

(f) Judicial and extrajudicial enforcement

20. As a general principle of debtor-creditor law, most States require claims to be enforced by judicial procedures. Creditors must sue their debtors, obtain judgement and then resort to other public officials or authorities (e.g. bailiffs, notaries or the police) to enforce the judgement. In order to protect the grantor and other parties with rights in the encumbered assets, some States impose a similar obligation on secured creditors, requiring them to resort exclusively to the courts or other governmental authorities to enforce their security rights. However, as court proceedings can be slow and costly, often they are less likely to produce the highest possible amount upon the disposition of the property being sold. In addition, because the expenses involved in enforcement will be factored into the cost of the financing transaction, inefficient processes will have a negative impact on the availability and the cost of credit.

21. To facilitate secured credit, some States require only a minimal prior intervention by officials such as courts, bailiffs or the police in the enforcement process. For example, the secured creditor may be required to apply to a court for an order of repossession, which the court will issue without a hearing. In other cases, once the secured creditor is in possession of the asset, it may sell it directly without court intervention as long as it hires a certified bailiff to manage the process according to prescribed procedures. The justification for a less formal approach lies in the fact that having the secured creditor or a trusted third party take control and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. A properly designed system can provide protection to the grantor and other persons with an interest in maximizing the amount that will be achieved from the sale of the encumbered assets while at the same time providing an efficient system for realizing the encumbered assets. Moreover, the knowledge that judicial intervention is readily available is often sufficient to create incentives for cooperative and reasonable behaviour that obviates the need to actually resort to the courts.

22. In some States, the secured creditor is not required to use the courts or other governmental authorities for any enforcement purposes, but is entitled to make

exclusive use of extrajudicial procedures. These States usually impose, in these cases, a number of mandatory rules relating to, for example, a notice of default or notice of intended disposition, the obligation to act in good faith and in a commercially reasonable manner, and the obligation to account to the grantor for the proceeds of disposition. In addition, they do not permit the secured creditor to take possession of the encumbered assets out of court if such enforcement would result in a disturbance of the public order. The purpose and effect of these requirements is to provide for flexibility in the methods used to dispose of the encumbered assets so as to achieve an economically efficient enforcement process, while at the same time protecting the grantor and other interested parties against actions taken by the secured creditor that, in the commercial context, are not reasonable. This Guide recommends that, in order to maximize flexibility in enforcement and thereby to obtain the highest possible price upon disposition, creditors should have the option of proceeding either judicially or extra judicially when enforcing their security rights (see A/CN.9/631, recommendation 136). In any event, in States that permit extrajudicial enforcement, the courts are always available to ensure that legitimate claims and defences of the grantor and other parties with rights in the encumbered assets are recognized and protected (see A/CN.9/631, recommendation 141).

23. Even in States where a secured creditor is permitted to act without official intervention, it is normally also entitled to enforce its security right through the courts. Moreover, because a security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation, post-default enforcement of the security right should not preclude a secured creditor from attempting to enforce the secured obligation by ordinary judicial process (see A/CN.9/631, recommendation 139). There are a number of reasons why a secured creditor might choose either of these options over extrajudicial enforcement. The secured creditor may wish to avoid the risk of having its actions challenged after the fact, or it may conclude that it will have to apply for a judicial proceeding anyway in order to recover an anticipated deficiency. Many States actually encourage secured creditors to use the courts by providing for less costly and more expeditious enforcement proceedings. They may, for example, permit enforcement through a process involving only affidavit evidence. They may also provide that the hearing must be held, challenges disposed of, and a decision rendered within a very short time period (e.g. 72 hours). Some States go even further and permit a secured creditor that has obtained judgement to dispose of the encumbered assets without having to use the official seizure and sale process. Finally, most States provide that these recourses are cumulative. A secured creditor that elects to pursue a judicial remedy may change its mind and later pursue an extrajudicial remedy to enforce its security rights to the extent exercise of a right does not make the exercise of another right impossible (see A/CN.9/631, recommendation 138).

(g) Scope of a secured creditor's enforceable rights

24. A general creditor that obtains judgement may enforce the judgement against all the debtor's property that procedural law allows to be seized. This generally will include all the debtor's property rights of whatever kind. If the debtor has only a limited right in property, only that limited right (e.g. a usufruct) may be seized and sold. Similarly, if a debtor's rights in property are limited by a term or a condition, the enforcement against the property will be likewise limited. The purchaser at the judicial sale may only acquire the property subject to the same term or condition.

25. Unlike the case of ordinary enforcement of judgements, the enforcement of security rights is subjected to an important additional limitation. A secured creditor may only proceed against the assets actually encumbered by its security right and not as against the grantor's entire estate (the secured creditor may, of course, proceed as an unsecured creditor against the grantor for claims beyond the amount of the secured obligation). Within this additional constraint, principles similar to those governing enforcement in general apply to the enforcement of a security right. The secured creditor may only enforce the security right against the particular rights that the grantor actually has in the encumbered assets. So, for example, if a grantor's ability to sell or otherwise dispose of, lease or license an encumbered asset is limited, the secured creditor's enforcement may not override those restrictions. This means that, if a grantor holds assets subject to a trademark licence, the security right would encompass only the grantor's right subject to enforceable terms in the trademark licence and would not give the secured creditor any general right to use or dispose of the trademark.

[*Note to the Commission: The Commission may wish to consider whether the order of recommendations 128-141 might be modified so as to more closely track the explanation provided in these commentaries.*]

3. Procedural steps preceding enforcement and the rights of the grantor

(a) General

26. States are required to develop procedural mechanisms to facilitate effective and efficient enforcement by the secured creditor and protection of the rights of the grantor and third parties with a right in the encumbered assets, regardless of whether the secured creditor (a) must obtain a judgement in the regular way, have a public official seize the encumbered assets and sell them at a public auction; or (b) has access to an expedited judicial remedy to have the debtor's default acknowledged, and is then able to proceed immediately to have a public official seize and sell the encumbered assets; or (c) is entitled to enforce its rights without judicial process. These procedural mechanisms are meant to ensure a balance between competing rights after default but prior to the effective exercise of the secured creditor's remedies. For this reason, States usually provide that these procedural mechanisms apply regardless of the particular remedy selected by the secured creditor. This means that they would apply whether the secured creditor (a) seizes and sells the encumbered assets privately, appropriating the proceeds of sale to the repayment of the outstanding obligation; (b) accepts the encumbered asset in payment of the secured obligation; or (c) takes possession of a business, operating it to pay the secured obligation.

(b) Notice of intended extrajudicial enforcement

27. Where a secured creditor elects to enforce the security agreement by bringing before the courts an ordinary action against the grantor with respect to the secured obligation, the normal rules of civil procedure (including those relating to notice of default and the opportunity for a hearing on the merits) will apply to both the judicial action itself and the post-judgement enforcement process. Usually, however, these rules only apply directly to the formal processes of courts. This is why States that permit extrajudicial enforcement typically enact separate rules governing extrajudicial enforcement. These rules are designed to ensure that the rights of

affected parties are adequately protected while at the same time providing for a maximum of flexibility in the enforcement process. Invariably, States require that secured creditors give a notice of their intention to dispose of the encumbered assets to all persons that may be affected by the disposition (e.g. the debtor, a third-party grantor and any person with rights in the encumbered assets).

28. The acknowledged need for a notice of extrajudicial disposition confronts States with a fundamental policy choice. In some States, a secured creditor must give an advance notice of its intention to pursue extrajudicial enforcement even before seeking to obtain possession of the encumbered assets. That is, the creditor must provide the grantor (and usually also third parties with a right in the encumbered assets) a written notice specifying the default, the encumbered assets, the creditor's intention to demand possession of the assets, the delay within which the grantor must either remedy the default or surrender the assets (typically 15-20 days) and, frequently, also the particular remedy that the creditor intends to follow in disposing of them. In other States, the timing of the notice is deferred and its substantive content is often less detailed. For example, in these States the secured creditor is not required to give prior notice of its intention to take possession, but is entitled to immediate possession of the encumbered assets at the same time that it gives formal notice of default to the grantor. Once in possession, however, the secured creditor usually may not dispose of the assets without giving the grantor and interested third parties an advance notice (typically 15-20 days) of the mode and manner of disposition that it proposes to follow if the grantor fails to remedy the default in the interim.

29. There are advantages and disadvantages to both of these approaches. The principal advantage of a regime that requires a prior notice of the secured creditor's intention to enforce and take possession of the encumbered assets is that it alerts the grantor and debtor to the need to protect their rights in the encumbered assets (invariably the debtor will be aware of its default but the third-party grantor may not be). This might involve, for example, challenging the enforcement, curing the debtor's default or seeking potential buyers for the encumbered assets. Notice to other interested parties allows them to monitor subsequent enforcement by the secured creditor, to contest the enforcement, or, if it is in their interest, to cure the default and, if they are secured creditors whose rights have priority (and the grantor is in default towards them as well), to participate in or take control of the enforcement process. The disadvantages of this type of notice include its cost, the fact that the secured creditor may have to elect a remedy before close inspection of the encumbered assets, the opportunity it provides an uncooperative grantor to remove the encumbered assets from the creditor's reach, and the possibility that other creditors will race to assert claims against the grantor's business and interfere with the disposition process. Moreover, unless formal and substantive requirements with respect to notices are clear and simple, there is a risk of "technical" non-compliance that will then generate litigation and its attendant cost and delay.

30. The advantage of a regime that requires only notice of extrajudicial disposition of the encumbered assets is that it secures the right of the secured creditor to take possession of the encumbered assets without undue delay, while protecting the interests of the grantor and third parties with rights in the encumbered assets at the time prior to disposition. The disadvantage is that the grantor is given notice of extrajudicial enforcement after the secured creditor takes possession of the

encumbered assets (this approach creates the problems mentioned in the preceding paragraph).

31. Regardless of which approach is taken, States must also decide what other notices may be required when a secured creditor seeks to enforce its security right extra judicially. Many States that require a prior notice of intended disposition of the encumbered assets do not also require a separate notice of default or a subsequent notice of extrajudicial enforcement. The assumption is that a single notice will be sufficient for all purposes. Other States that permit the notice of the specific extrajudicial enforcement method being pursued to be given after the creditor obtains possession of the encumbered assets, nonetheless require a pre-possession formal notice of default. Because the objective and contents of the pre-possession notice of intention to enforce and the post-possession notice of extrajudicial enforcement largely overlap, no States that opt for the former also require the latter. To balance the interests of all parties, this Guide recommends that the secured creditor may take possession of the encumbered assets without applying to a court, provided that the grantor has consented to extrajudicial enforcement in the security agreement, does not object when the secured creditor seeks to obtain possession, and has given the grantor notice of default and of its intention to seek to obtain possession out of court (see A/CN.9/631, recommendation 143).

32. As with other situations where notice may be required, States usually specify with considerable care the minimum contents of a notice, the manner in which it is to be given and the persons to whom it must be given, in addition to its timing. Many States distinguish between notice to the debtor, notice to the grantor when the grantor is not the debtor, notice to other creditors and notice to public authorities or the public in general. It is a matter of a cost-benefit analysis whether the secured creditor should be required to give prior written notice to others beyond the debtor and grantor and other secured creditors known to exist (i.e. other secured creditors that have registered a notice of their rights or that have otherwise notified the secured creditor that proposes to dispose of the encumbered assets). Some States provide that the notice need be given only to the grantor and other secured creditors that have registered their rights, but that it then be registered and that thereafter the registrar be required to forward the notice to all those who have registered rights against the encumbered assets.

33. States also take different approaches to the minimum content of the notice. As with the decision about the timing of the notice and its recipients, decisions about the information to be included require States to undertake a cost-benefit analysis. For example, they might require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default. They might further require advice to the debtor or grantor regarding what steps to take to pay the secured obligation in full or, if such a right exists, to cure the default. Moreover, some States provide that the notice to other interested parties need not be as extensive or specific as notice to the debtor and grantor. Again, where the notice is to be given prior to taking possession, States often place a higher information burden on secured creditors. Where the notice is given after possession, by contrast, the secured creditor is often obliged simply to provide basic information about the date, time, location and type of disposition being proposed and the delay within which the grantor or other interested party may contest the proposal or remedy the default.

34. There are different approaches to achieving the right balance between the need to ensure that the notice conveys to interested parties sufficient information to enable them to make an informed judgement about how best to protect their rights, and the need to achieve expeditious and low-cost enforcement. Some States place a heavy burden on secured creditors, both as to the timing and the content of the notice. Others impose only minimal requirements. This Guide recommends that the notice normally should be given prior to the secured creditor commencing enforcement (see A/CN.9/631, recommendation 145) and that rules should provide for it to be given in a timely, efficient and reliable way (see A/CN.9/631, recommendation 146), but that States have the flexibility to determine the specific manner for giving the notice and its specific contents (see A/CN.9/631, recommendation 147).

(c) Release of the encumbered assets and reinstatement of the secured obligation

35. Once a default has been signalled, the debtor, third-party grantor and interested third parties will often attempt to refinance the secured obligation or otherwise remedy the alleged default. In such cases, States must decide what rights these different parties may exercise and within what time frame they may be exercised. Typically grantors and third parties are given two types of right: release of the encumbered assets; and reinstatement of the secured obligation.

36. Release brings the secured transaction to an end because the grantor's obligation has been fully repaid. Since the objective of enforcement proceedings is to enable creditors to obtain repayment of the obligation, States are usually quite flexible about the parties entitled to pay the secured obligation. For example, most States permit a defaulting grantor to seek to obtain a release of the encumbered assets before their final disposition by the secured creditor upon paying the outstanding amount of the secured obligation, including interest and the costs of enforcement incurred up to the time of repayment. States usually also permit any interested third party (e.g. a creditor with a lower priority ranking than that of the enforcing creditor or a purchaser that takes the assets subject to the security right) to exercise the right of repayment if the grantor does not.

37. In addition, States usually take a flexible position in relation to the time within which repayment may be made. The secured creditor's interest is in being paid. As long as this payment of principal, interest and costs of enforcement incurred occurs before any third-party rights are affected, there is no reason for insisting on disposition of the encumbered asset. That is, whoever exercises the right may do so up until the time of (a) disposition of the encumbered asset or the completion of collection by the secured creditor after disposition of the encumbered asset; (b) the secured creditor entering into a commitment to dispose of the encumbered asset; or (c) acceptance by the secured creditor of the encumbered asset in total or partial satisfaction of the secured obligation, whichever occurs first. Until one of these events occurs, the secured obligation may be repaid in full and the encumbered assets released. For the same reasons (recognizing that the creditor's primary interest is in receiving payment and the grantor's primary interest is in not losing its property), this Guide recommends that repayment leading to release of the encumbered assets be permitted right up until third-party rights are acquired or the secured creditor has accepted the encumbered asset in satisfaction of the secured obligation (see A/CN.9/631, recommendation 140).

38. Reinstatement of the secured obligation is quite different from release of the encumbered assets and is usually more narrowly circumscribed. Reinstating the secured obligation means curing the specific default (e.g. paying any missed instalments, accrued interest and costs of enforcement already incurred), but otherwise it has no effect either on the grantor's continuing duty to perform or on the security right. The reinstated obligation remains enforceable according to the terms agreed by the parties and remains secured by the encumbered assets.

39. States take quite different approaches to the reinstatement right. Some do not legislatively provide for a reinstatement right, but allow parties to provide for such a right in the security agreement. By contrast, many States provide for such a right but limit its exercise to the grantor. Finally, some States permit any interested party to cure a default and reinstate the secured obligation. Whenever reinstatement is permitted, parties authorized to do so may exercise the right up to the same time that parties authorized to release the encumbered assets may exercise their right of release. Because reinstatement maintains rather than extinguishes the secured obligation, the grantor may later again fall into default. To prevent a series of strategic defaults and reinstatements, States often limit the number of times that a secured obligation may be reinstated after default.

[*Note to the Commission: The Commission may wish to consider adding a recommendation on the grantor's right to cure the default and reinstate the secured obligation.*]

(d) Authorized disposition by the grantor

40. Following default, the secured creditor will be interested in obtaining the highest price possible for the encumbered assets. Frequently, the grantor will be more knowledgeable about the market for the assets than the secured creditor. For this reason, secured creditors will often permit the grantor to dispose of the encumbered assets even after enforcement has commenced. In most such cases, the parties agree that any amount received from the disposition will be paid to the secured creditor in the same manner as if payment resulted from enforcement proceedings. These arrangements have consequences for third parties that may also have rights in the encumbered assets, or a right to proceeds of their disposition. For this reason, some States explicitly provide that when a secured creditor that has commenced enforcement gives the grantor a limited time following default to dispose of the encumbered assets, the proceeds of the sale will, for all purposes, be treated as if they had arisen as a consequence of an enforcement disposition. Some States go further, and even prohibit the secured creditor from attempting to arrange for the disposition of the encumbered assets during a short period of time following default. Other States seek to achieve the objective of maximizing the amount received upon disposition by providing incentives for the grantor to bring potential buyers to the attention of the secured creditor. In any event, the point is to structure the enforcement regime so as to give the grantor the incentive to cooperate with the secured creditor in disposing of encumbered assets for the highest possible price.

4. Extrajudicial enforcement of the rights of the secured creditor

(a) General

41. In cases where a secured creditor elects to enforce the security agreement judicially, after judgement has been obtained, the normal rules of civil procedure relating to the post-judgement enforcement process will apply. Typically, this means that public officials or authorities (e.g. bailiffs, sheriffs, notaries or the police) will take possession of the encumbered assets and bring them to sale. Slightly different processes are required where a secured creditor has taken the steps that are necessary to commence enforcement proceedings and elects to exercise its rights out of court. As no public official is involved, the secured creditor will normally wish to, and typically will have to, obtain possession or control of the encumbered asset itself in order to proceed with enforcement. States have taken different policy approaches both to the right of the secured creditor to obtain possession and control of assets (as opposed to consigning encumbered assets to a bailiff) and, if direct creditor possession is permitted, to the procedural mechanisms that must be followed for doing so.

(b) Removing the encumbered assets from the grantor's control

42. Prior to default, the grantor will usually be in possession of the encumbered assets. Sometimes, however, the grantor will have already placed the secured creditor in possession, either at the time of making the security right effective between them (see A/CN.9/631, recommendation 14) or thereafter either as a means of achieving third-party effectiveness (see A/CN.9/631, recommendation 38) or in response to a later pre-default creditor request to control the assets. On other occasions, the encumbered assets may be in the possession or the control of a third party that is acting for, or under the direction of, the secured creditor. In both these situations, many States do not require the secured creditor to take any further steps in order to commence enforcement. That is, the creditor need not formally give the grantor notice of default, but need only send a notice of intended disposition once it has determined the recourse it intends to pursue. By contrast, some States require the creditor in possession to inform the grantor of the default and of the fact that it is now holding the encumbered assets in preparation for enforcement. These States usually also consider that, upon default, any agreement under which the creditor in possession may use the encumbered assets comes to an end.

43. Where the creditor is not in possession, it must take active steps to recover the encumbered assets from the grantor or to inform a third party holding on behalf of the grantor that the security right has become enforceable. States that provide for extrajudicial enforcement generally provide that, once a grantor is in default, the secured creditor has an automatic right to possession of the encumbered asset. That is, they do not require that, pending extrajudicial enforcement, the assets be placed under the control of a public official. The assumption is that flexibility in enforcement and lower-cost preservation of the assets pending disposition will result if the secured creditor can make decisions about where post-default possession and control should lie. This rationale also underlies the recommendation in this Guide that the secured creditor has upon default an automatic right to possession (see A/CN.9/631, recommendation 142).

44. A concomitant of the secured creditor's right to possession is its right to decide exactly how that possession should be exercised. In some cases, secured creditors will actually take personal possession of the encumbered assets against which they are proceeding. However, in many cases, they will not take possession of the assets. Secured creditors may, for example, have the assets placed in the hands of a court, or a State- or court-appointed official. More commonly, they will have the assets entrusted to a third-party depositary that they appoint, or (particularly in the case where a manufacturing operation is involved) will appoint a manager to enter into the premises of the grantor in order to take control of the encumbered assets. Where assets are already in the hands of a third party that is not acting for them, but that has previously been made aware of the security agreement, secured creditors may simply give notice that the agreement has become enforceable and that the grantor no longer has rights to retain possession, to control or to dispose of the encumbered assets.

45. States usually consider the taking of possession to be a significant step in the enforcement process and impose specific procedural requirements on creditors claiming possession. That is, even though the secured creditor may have an automatic right to possession, the manner for doing so is regulated. In general, States take one of three approaches in developing the procedural mechanisms by which secured creditors not in possession may remove encumbered assets from the grantor's control. In some States, the secured creditor may only obtain possession by a court order, whether following an ex parte procedure, or more frequently, after a hearing. In other States, no judicial order is required, but the grantor must have authorized the creditor to obtain possession extrajudicially in the security agreement and the creditor must give the grantor a prior notice (typically 10 or 20 days) of its intention to claim possession and to enforce. Finally, in some States, the creditor is entitled to demand and to take possession without any recourse to a court and without the need to give the grantor a prior notice of its intention to do so, provided that the grantor authorized it to do so in the security agreement. Even in these States however, the creditor does not have an absolute right to obtain possession extrajudicially. There is always potential for the creditor abusing its rights by threatening the grantor, intimidation, breaching the peace or claiming the encumbered assets under false pretences. Most of these States, therefore, condition any acts of the creditor to obtain possession on the creditor avoiding a disturbance of the public order. Should the grantor resist, a judicial order for possession would be required. States that permit extrajudicial creditor possession upon the giving of a 10 or 20 day prior notice typically also adopt this approach to possession and require a judicial order if a breach of the peace is threatened when the creditor seeks possession after the delay has expired.

46. In States that impose a notice requirement on secured creditors as a precondition to obtaining possession, there is always a risk that a grantor in default may then seek to hide or transfer the encumbered asset before the secured creditor can take control of it. It may also be that the assets may be misused, may dissipate if not looked after or, depending on market conditions, may rapidly decline in value. To forestall these possibilities, most States provide that secured creditors may obtain expedited relief from a court or other relevant authority. Furthermore, in the special case where the encumbered assets threaten to decline rapidly in value, and whether or not secured creditors are required to give a prior notice of their intention to

enforce, many States permit the court to order the immediate sale of these perishable assets.

47. The decision as to the formalities required in order for a secured creditor to obtain possession depends on the balance States strike between the protection of the rights of grantors and efficient enforcement to reduce costs. It also depends on a judgement as to the likelihood in practice of abuse by secured creditors or improper behaviour by grantors in possession. In order to reduce the cost of enforcement and minimize the chances that assets will be misused or dissipate in value, this Guide recommends that the secured creditor be authorized to obtain possession extrajudicially, but only if the grantor has so authorized in the security agreement, a notice of intention to take possession has been given to the grantor, and the grantor does not object at the time possession is being sought (see A/CN.9/631, recommendation 143). In addition, to maximize enforcement value where assets are perishable or are likely to decline rapidly in value during the period between the giving of notice and the time when the creditor may actually obtain possession of the assets, this Guide recommends that, as long as the grantor has authorized extrajudicial possession in the security agreement and the grantor does not object when possession is actually being sought, notice of the creditor's intention to take possession and to dispose of the assets need not be given (see A/CN.9/631, recommendation 145).

(c) Sale or other disposition of the encumbered assets

48. Because a security right entitles the secured creditor to obtain the value from the sale of the encumbered assets and to apply it to the secured obligation, States usually regulate in some detail the procedures by which the secured creditor may seize and dispose of these assets. Requirements range from the less to the more formal. For example, even when extrajudicial enforcement is permitted, some States require disposition to be subject to the same public procedures used to enforce court judgements. Other States require secured creditors to obtain judicial approval of the proposed mode of disposition before proceeding. Still other States permit the secured creditor to control the disposition but prescribe uniform procedures for doing so (e.g. rules relating to public auctions or a call for tenders). On occasion, States actually oblige the secured creditor to obtain the consent of the grantor as to the mode of disposition. Finally, some States give the secured creditor a wide, unilateral discretion as to the mode of disposition, but subject this conduct to general standards of conduct (e.g. good faith and commercial reasonableness), the breach of which leads to the creditor's liability in damages.

49. Most commonly, the procedural safeguards by which States control the actions of secured creditors relate to the details of the notice that must be given to the grantor and third parties with a right in the encumbered assets. In principle, the types of detail required should be identical whether States opt for a pre-possession notice approach or a post-possession notice approach. So, for example, States often require creditors to indicate the method of advertising a proposed disposition, the date, time and location of the sale, whether the sale will be by public auction or by tender, whether the assets will be sold individually, by lot or as a whole, and whether the disposition includes leases, licences or associated permits where required. The objective should be to maximize the amount realized for the encumbered assets, while not jeopardizing the legitimate claims and defences of the

grantor and other persons. This explains why even States that generally require detailed notices do not do so when the encumbered assets are to be sold on a recognized public market. In such cases, the market sets the value of the assets and there is no higher price to be obtained by adopting and giving notice of some other mode of sale (see A/CN.9/631, recommendation 145).

50. Because an extrajudicial disposition of encumbered assets has the same finality as a court-supervised sale, most States not only impose relatively detailed rules as to the contents of the notice and the time that must elapse before the sale can take place, but also permit interested parties to object to the timing and manner of the proposed disposition. Typically, special expedited procedures are available so that objections may be quickly heard and dealt with (see A/CN.9/631, recommendations 137 and 141). As a general rule, where the enforcing creditor has the greatest flexibility as to timing and method of disposition, the cost of enforcement is lowest, the enforcement is most expeditious and the proceeds received are highest. For these reasons, this Guide recommends flexibility for secured creditors and only the basic minimum of detail in the notice necessary to alert interested parties to the enforcement and the need to protect their interests should they wish (see A/CN.9/631, recommendations 146 and 147).

(d) Acceptance of the encumbered assets in satisfaction of the secured obligation

51. The underlying rationale for creating a security right is to enable the secured creditor to realize the value of the encumbered asset and to apply the money received to payment of the grantor's obligation. For this reason, in many States, a creditor's only recourse upon default is to seize the encumbered assets and sell them. In most States that so limit the secured creditor's extrajudicial recourses, the limitation applies even when the creditor is already in possession of the encumbered assets under a pledge agreement. That is, in these States it is not possible for the parties to agree in advance that, should the grantor default, the secured creditor may keep the encumbered assets in satisfaction of the secured obligation. Similarly, in many of these States, the secured creditor may not take the encumbered assets as a remedy after default has occurred. Moreover, even if, after default, the grantor and the secured creditor agree that the secured creditor may keep the encumbered assets, in these same States such arrangements are considered as a contractual payment and have no effect on the rights of any other party with a right in the encumbered assets.

52. By contrast, in many States, the secured creditor is entitled to propose to the grantor that it accept the encumbered assets in full or partial satisfaction of the secured obligation. Where such an enforcement remedy is made available to secured creditors, States usually provide that any agreement that automatically vests ownership of the encumbered assets in the secured creditor upon default is unenforceable if entered into prior to default. However, the agreement is enforceable if made after default and according to the specific enforcement procedures meant to prevent creditor abuse. These States usually also provide that any informal private agreements entered into by grantors and secured creditors after default are enforceable, but only as contractual payment remedies that have no effect on third parties with rights in the encumbered assets.

53. Where States expressly permit the creditor to take the encumbered assets in satisfaction of the secured obligation after default, provided that it has followed the required procedural steps, this does not mean that the grantor must accept the

secured creditor's offer. The grantor may refuse to do so, with the consequence that the secured creditor will have to pursue one of its other remedies. The advantage of permitting these types of post-default agreement is that they can often lead to less expensive and more expeditious enforcement. The disadvantage is that there may be a risk of abuse by the secured creditor in cases where (a) the encumbered assets are more valuable than the secured obligation; (b) the secured creditor has, even in the post-default situation, unusual power over the grantor; or (c) the secured creditor and the grantor come to an arrangement that unreasonably prejudices the rights of third persons with a right in the encumbered assets.

54. To guard against the potential for abusive or collusive behaviour by the secured creditor and the grantor, some States require not only the consent of the grantor to the acceptance by the secured creditor, but also that notice be given to third parties with rights in the encumbered assets. These third parties then have a right to object to the proposed agreement and may require the secured creditor to enforce the security by means of a sale. In addition, some States require the consent of a court under certain circumstances, such as where the grantor has paid a substantial portion of the secured obligation and the value of the encumbered assets greatly exceeds the outstanding obligation. Finally, some States require that a secured creditor that proposes to accept encumbered assets in satisfaction of the secured obligation be required to provide an official and independent appraisal of the value of the encumbered assets before proceeding.

55. Whether States should impose any or all of these requirements, and especially the requirement of prior judicial involvement, will depend on their assessment of the costs and benefits of each requirement. In line with the general objective of maximizing flexibility so as to obtain the highest possible value for encumbered assets at the point of enforcement, this Guide recommends that either the secured creditor or the grantor may propose to the other that the assets be taken in satisfaction of the secured obligation (see A/CN.9/631, recommendations 148 and 151). Likewise, to ensure that all parties understand the full implications of the proposal, this Guide recommends that adequate notice of the secured creditor's intention to accept the assets in payment is given to the grantor and third parties, and that the notice indicates not only the assets to be taken in satisfaction, but also the amount owed at the time the notice is sent, the amount of that obligation that is proposed to be satisfied by the acceptance, and a relatively short period of time at the expiration of which the proposal will be deemed to be accepted (see A/CN.9/631, recommendation 149). The assumption is that requiring the secured creditor to indicate its own valuation of the encumbered assets is a more efficient and less costly mechanism for providing relevant information to interested parties than providing for an independent appraisal. It is also assumed that, once informed of the secured creditor's proposal, the grantor or third parties will be in a position to assess its reasonableness. This is why this Guide further recommends that the grantor or third parties that object to the proposal have a right to require the secured creditor to abandon this recourse and proceed rather to a sale in disposition (see A/CN.9/631, recommendation 150).

(e) Management and sale of a business

56. In many circumstances a secured creditor has security not just on specific assets of a grantor, but on most or all of the assets of a business. In these situations,

the highest enforcement value can often be obtained if the business is sold as a going concern. In order to be able to do so efficiently, secured creditors must usually be able to dispose of all these assets, including immovable property. Moreover, in such cases, States often prescribe special notice procedures for the sale and more strictly regulate the conditions under which the sale of a business as a going concern may take place.

57. Alternatively, in many cases where enforcement becomes necessary, it is not in the interest of the grantor or the secured creditor to immediately dispose of all the assets of a business, whether these are sold by category (e.g. inventory, equipment and licences) or whether the business is sold as a whole. For this reason, many States permit secured creditors to take possession of business operations and manage the business for a certain period of time after default. Frequently, these States require that the notice of enforcement specifically indicate that when the creditor takes possession of the encumbered assets it intends to gradually wind down the business. This is especially important for other creditors that otherwise may not know that liquidation is taking place. Some States also prescribe special procedures for naming a manager, for operating the business, for alerting suppliers of the secured creditor's rights and for informing customers that what looks like an ordinary-course-of-business sale is in fact part of an enforcement process.

58. When inventory has been effectively liquidated, the secured creditor will typically proceed to exercise another of its remedies. In such cases, most States require the secured creditor to give a further notice to the grantor and other parties with a right in the remaining assets (most often equipment, leases, licences and a remnant of inventory) that it proposes to exercise another of its remedies (e.g. accepting the assets in satisfaction, or more commonly, selling them). Once such a notice is given, then the regular enforcement procedures applicable to that recourse will apply.

[*Note to the Commission: The Commission may wish to consider adding a recommendation on the secured creditor's right to take over the management of a business and to sell the assets as it winds down that business.*]

(f) Remedies cumulative

59. It will sometimes happen that, in order to completely dispose of all the encumbered assets, a creditor will be obliged to exercise more than one remedy. As noted, this typically occurs when a secured creditor liquidates a business. However, it may occur because, for example, security in inventory may be most effectively enforced through a sale, or security in equipment may be most efficiently enforced through the acceptance of the assets by the secured creditor in satisfaction of the secured obligation. In addition, there will occasionally be situations where a secured creditor believes that one remedy will be optimal, only to discover that another will generate a higher value upon disposition. This is why most States provide that a secured creditor's remedies are cumulative. That is, the enforcing creditor may not only have the option of selecting which recourse to pursue, it may exercise different remedies either at the same time or one after the other. It may even concurrently pursue both judicial and extrajudicial remedies. Only where the exercise of one remedy (e.g. repossession and disposition of an encumbered asset) makes it impossible to exercise another remedy (e.g. acceptance of an encumbered asset in satisfaction of the secured obligation) will the creditor not be able to cumulate

remedies. Here also, the Guide adopts the policy that maximizing flexibility in enforcement is likely to ensure that the highest value is received for the encumbered assets and recommends that secured creditors be permitted to cumulate their judicial and extrajudicial remedies (see A/CN.9/631, recommendation 138).

60. A security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation. The various post-default enforcement remedies, and especially extrajudicial remedies of the secured creditor, are meant to achieve this objective. Some States do not permit secured creditors to cumulate both their remedies with respect to the encumbered assets and their remedies with respect to the secured obligations. The assumption is that these extrajudicial remedies are a favour given to the secured creditor and that the creditor ought, therefore, to be required to opt either to enforce the security right or to bring a judicial action to enforce the secured obligation. Other States permit the secured creditor to cumulate both its extrajudicial remedies and its right to enforce the obligation as a matter of contract law. Moreover, they permit the two proceedings to be brought concurrently or serially in either order. To require a secured creditor to opt, at the outset of enforcement, for one or the other mode of proceeding will complicate and increase the cost of enforcement because it will require a creditor to determine if a deficiency is likely to result. If it comes to that conclusion it will be obliged to bring an action to enforce the obligation and assert its priority only at the moment of a judicial sale in enforcement. This is a less expeditious process, is more costly, and will normally produce less value at the time of sale. To maximize enforcement value, this Guide recommends that secured creditors be permitted to cumulate proceedings to enforce the security extrajudicially and to enforce the secured obligation through a judicial process, subject always to the limitation that the secured creditor cannot claim more than it is owed (see A/CN.9/631, recommendation 139).

5. Effects of enforcement

(a) The grantor, the secured creditor and third parties

61. In order to make the enforcement regime as expeditious as possible, States typically enact detailed rules that determine the effect of enforcement on the relationship between the grantor and the secured creditor, the rights of parties that may purchase the encumbered assets at an enforcement sale, and the rights of other secured creditors to receive the proceeds generated by the sale of the encumbered assets. The primary object of an enforcement procedure is, of course, to generate value for the secured creditor that can be deployed to satisfy the unpaid secured obligation. In the most common situation, the secured creditor will acquire this value by selling the encumbered assets and appropriating the proceeds. Should there be a surplus, the secured creditor must return this to the grantor or to any other person entitled to it. Moreover, as just noted, should there be a deficiency, most States provide that the secured creditor retains an ordinary contractual right to sue the grantor for the deficiency as an unsecured creditor. The details of how proceeds of distribution are normally allocated in these cases are discussed below (paras. 67 and 68).

62. As noted, however, sometimes the secured creditor will take the encumbered asset in satisfaction of the secured obligation. Not all States adopt identical rules to govern the effects of this particular recourse. Usually, States provide that the creditor that takes the asset in satisfaction may keep it, even where the value of the

asset exceeds the amount of the secured obligation still owed. That is, unlike the case of a sale, the secured creditor may keep a surplus. Concomitantly, many of these States provide that the secured creditor that accepts the asset in satisfaction of the obligation has no recourse for a deficiency against the grantor. The acceptance is deemed to be complete payment and therefore extinguishes the secured obligation. By contrast, however, other States permit creditors that have taken encumbered assets in satisfaction of the secured obligation to pursue their grantor for a deficiency. In these cases, of course, it becomes necessary to establish the value of the assets being taken in satisfaction so that the amount of the deficiency may be calculated. Some States require the secured creditor to provide an independent accounting of the value of these assets taken, while other States merely require the secured creditor to indicate the value that it ascribes to these assets. In either case, as noted, the grantor or other creditor may require the secured creditor to sell the asset instead. For reasons already given (see para. 55 above), this Guide recommends that secured creditors may take the asset in total or partial satisfaction of the secured obligation, provided that they indicate the value they ascribe to it in the notice sent to the grantor and third parties (see A/CN.9/631, recommendation 149).

(b) Other parties

63. When a secured creditor enforces its security right by means of a sale of the encumbered assets, there are different approaches to determining the effects of the sale on other parties. In some States, the sale (even when it is an extrajudicial sale) will purge all security rights in the encumbered assets. In such cases, even secured creditors with a priority ranking higher than that of the enforcing secured creditor will lose their security and will only have a claim in the proceeds with an equivalent priority ranking. Parties that purchase the assets will obtain a clear title and, it is presumed, will be willing to pay a premium to do so. In other States, the sale by a creditor (whether it is managed by a judicial officer or it is a private sale by the creditor) will only extinguish rights with a lower priority ranking than that of the enforcing secured creditor and the secured creditor with a higher priority ranking will retain its security right in the encumbered assets. Purchasers at the sale will not obtain a clear title and will, consequently, discount the amount they offer for the assets being sold. The assumption is that the highest ranking secured creditor normally will either take over the enforcement (so that all security rights will be extinguished) or that a lower ranking secured creditor will arrange to pay off the higher ranking creditor so as to produce a clear title. While either approach usually will produce a clear title, the second approach maximizes the flexibility of the enforcing creditor and the purchaser to reach an alternative arrangement in the event that the purchaser cannot finance the entire cost of the secured asset and is willing to purchase it for a discounted price because it is subject to a higher ranking security right. To maximize flexibility and efficiency in enforcement, this Guide recommends adoption of the second approach (see A/CN.9/631, recommendation 158).

64. When a secured creditor takes the encumbered assets in satisfaction of the secured obligation, States usually provide that the secured creditor takes the assets as if they were transferred through an enforcement sale. While it is possible that States could provide that an acceptance in satisfaction of the secured obligation operates a purge of all rights, this would invariably lead secured creditors with a

higher priority ranking than that of the enforcing secured creditor to take over the enforcement process. Therefore, most States provide that the rights of other secured creditors are determined by their priority relative to the enforcing creditor. So, for example, where a State permits a secured creditor to take an encumbered asset in satisfaction of the secured obligation, that creditor will acquire the asset subject to the rights of secured creditors with a higher priority ranking. Conversely, if there are secured creditors with even lower priority, their rights will normally be extinguished upon acceptance of the encumbered assets by a secured creditor with higher priority. For the same reasons that apply to the remedy of extrajudicial sale, this Guide recommends that the secured creditor that accepts the asset in satisfaction takes it free of lower priority security rights, but subject to the rights of secured creditors with a higher priority (see A/CN.9/631, recommendation 158).

65. The secured creditor that has a higher priority will often wish to take over an enforcement process commenced by another creditor (whether this is under judgement enforcement proceedings or enforcement being pursued by another creditor exercising a security right). States usually provide for a takeover right from secured creditors enforcing under secured transactions law, but some do not permit secured creditors to pursue extrajudicial enforcement once a judgement creditor (whether an unsecured judgement creditor, or a secured creditor that may have also taken judicial enforcement proceedings) has seized the encumbered assets. Where a takeover right is given to a secured creditor against enforcement by a judgement creditor, States often require the secured creditor to exercise the right in a timely manner (i.e. before the auction begins) and to reimburse the judgement creditor for enforcement expenses incurred up to that moment. In order to maximize the efficiency of the enforcement of security rights, this Guide recommends that a secured creditor with a priority ranking higher than that of the enforcing secured creditor is entitled to take control of enforcement both against other secured creditors pursuing extrajudicial enforcement and as against judgement creditors (see A/CN.9/631, recommendation 156).

(c) Allocation of proceeds of disposition

66. One of the important features of secured transactions law is that it disrupts the normal rules for distributing the proceeds of disposition that apply as between unsecured judgement creditors. After all, the object of the security is to obtain a priority in the distribution of these proceeds. Should the enforcement of the security right have taken place judicially or should the secured creditor not have taken over an enforcement process brought by a judgement creditor, the proceeds will be held by a public authority pending their distribution to parties entitled to them. When the regime provides for a purge of rights, the most common allocation is to pay reasonable enforcement costs first and then the secured obligations in the order of their priority. Many States also provide for the payment of certain statutory claims, after costs of enforcement but in priority to secured creditors. If the ordinary enforcement process does not provide for a purge of rights, secured creditors will not receive payment, but will be able to assert their security rights against the purchaser.

67. Where a secured creditor enforces through an extrajudicial sale, States typically provide in their secured transactions law a series of rules relating to the proceeds of the sale. Often there are special rules dealing with the manner by which

proceeds are to be held by the secured creditor pending distribution. These rules usually also prescribe if and when a secured creditor is responsible for distributing proceeds to some or all other creditors (such as secured creditors with security rights in the encumbered assets with a lower priority ranking than that of the enforcing secured creditor or, if the enforcement regime provides for a purge of rights, to secured creditors with a higher priority ranking and statutory priority claimants). Often, the secured creditor need only take account of these other rights if they are registered or have otherwise been made effective against third parties, or if it has been expressly notified of them (e.g. the case of statutory priority claims that need not be registered). Invariably States also provide that any surplus proceeds after all creditors entitled to payment have been satisfied are to be remitted to the grantor (see A/CN.9/631, recommendation 152).

68. The secured obligation is discharged only to the extent of the proceeds received from the sale of the encumbered assets. Normally, the secured creditor is then entitled to recover the amount of the deficiency from the grantor. Unless the grantor has created a security right in other assets for the benefit of the creditor, the creditor's claim for the deficiency is an unsecured claim. Regardless of whether there is a deficiency or a surplus, some States provide that, when a secured creditor purchases the encumbered assets at an enforcement sale and later sells them at a profit, the amount received for the sale that exceeds the amount paid by the creditor and the costs of the further sale, is deemed to be received in satisfaction of the secured obligation. Generally, however, unless the initial sale can be shown to have been commercially unreasonable, States consider the amount generated to be the final value received upon disposition of the encumbered assets.

(d) Finality

69. Secured transactions laws normally provide finality following enforcement. This means that, once the sale or acceptance in satisfaction has taken place according to the required enforcement procedures, it normally cannot be reopened. Unless fraud, bad faith or collusion between seller and buyer can be proved, the sale is final. Whether the secured creditor accepts the encumbered asset in satisfaction of the secured obligation or whether the assets are sold to a third party that acquires them at an enforcement sale, the effects of the enforcement on other parties are usually the same. The security right in the encumbered assets terminates, as do the grantor's rights and the rights of any secured creditor or other person with a lower priority ranking in the assets. In States where the sale produces a total purge of rights in the encumbered assets, the purchaser or the creditor that takes the encumbered assets in satisfaction of the secured obligation obtains a clear title. Most often, however, the law provides that the rights of certain other persons in the encumbered assets (most notably secured creditors with a higher priority ranking than that of the enforcing secured creditor) continue notwithstanding disposition of the assets in the enforcement procedure.

B. Asset-specific remarks

1. General

70. The basic principles governing enforcement of security rights just reviewed ought generally to apply whatever the type of encumbered asset. Nonetheless, they primarily envision certain types of tangible property, such as inventory, equipment and consumer goods. For this reason, these rules do not easily apply either to the enforcement of security rights in intangible property, such as receivables and various payment rights (such as rights to payment of funds credited to a bank account) and proceeds under an independent undertaking, or to payment rights arising from negotiable instruments and rights to possession arising from a negotiable document (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). Consequently, many States have enacted special rules governing enforcement against these types of encumbered asset and in particular in respect of payment rights. These include, among others, provisions giving the secured creditor the right to collect from the person obligated on the receivable or negotiable instrument and requiring that person to make payments directly to the secured creditor. Moreover, in many of these cases, secured transactions law must accommodate, and in part defer to, the specialized law and commercial practices governing bank accounts, negotiable instruments, negotiable documents and independent undertakings.

71. As previously mentioned, the basic principles in section A of this chapter generally envision encumbered assets as tangible property acquired, used and sold as separate objects. Yet tangible property is often attached to other movable or immovable property, or commingled in a mass, or manufactured into a product. These dealings require States to adjust the general regime to govern enforcement of competing security rights in attachments and manufactured products. This is most notably the case when tangible property is attached to, or detached from, immovable property. For example, there may be priority conflicts between creditors enforcing a mortgage on land and creditors with a security right in an attachment to that land. The most common of these different situations and the different approaches that States can take to ensure efficient enforcement of competing security rights are considered in turn.

2. Enforcement of a security right in a receivable

72. When a security right is taken in a receivable, the encumbered asset is the grantor's right to receive payment from the debtor of the receivable (for the definitions of the terms "receivable", "assignment", "assignor", "assignee" and "debtor of the receivable", see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). While it would be theoretically possible to require the assignee to enforce the assignment by seizing the receivable and either selling it or keeping it in satisfaction of the secured obligation, this would be a cumbersome and inefficient way of realizing the economic value of the asset. This is the reason why most States that permit creditors to take security in receivables and other claims, enable the assignee to collect payment directly from the debtor of the receivable once the assignor is in default. The primary concerns are two: first, that the assignor knows that the assignee is enforcing (either after default, or with the

agreement of the grantor before default); and second, that the debtor of the receivable knows that it must thereafter make payments to the assignee.

73. In chapter VIII, Rights and obligations of the parties, this Guide discusses the relationship between the assignor, the assignee and the debtor of the receivable. Issues discussed include, for example, the right of the assignee to inform the debtor of the receivable to make payments directly to the assignee following the assignor's default (see A/CN.9/631, recommendations 110-113). The Guide also provides, in chapter IX, Rights and obligations of third-party obligors, that the debtor of the receivable is protected against having to pay twice by the notification and payment instruction given by the assignee or the assignor (see A/CN.9/631, recommendations 114-120).

74. Many States take the position that the assignee's primary enforcement right is simply to collect the receivable. Assuming that it has followed the steps required to make its rights effective against the debtor of the receivable, the assignee will simply collect payment, applying the proceeds to reduction of the assignor's obligation. The rationale is that the rights of the assignor and third parties will be protected simply by the normal application of the money received to a reduction of the secured obligation. Consistent with the approach taken by these States, this Guide recommends that no further steps to achieve enforcement need be taken (see A/CN.9/631, recommendation 163).

75. Nonetheless, there may be cases where the assignee may wish to appropriate the entire present value of a receivable that may be spread out in instalments due over several months. It may, therefore, after notifying the debtor of the receivable that it will be collecting the account, sell or transfer the receivable to a third person. To protect the assignor's rights in such cases, many States provide that the assignee may not keep any excess, a position this Guide adopts not only in relation to such dispositions of receivables, but also in relation to the ordinary collection of receivables (see A/CN.9/631, recommendation 113, subpara. (b)). Moreover, the assignee must act in a commercially reasonable manner in disposing of the receivable (see A/CN.9/631, recommendation 128).

76. In some cases, the receivable itself will be secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right on movable property of the debtor of the receivable). Many States provide for an automatic right of the assignee to enforce these other rights should the debtor of the receivable be in default to pay the receivable as it falls due. This is a normal consequence of a security right (the accessory follows the principal) and this Guide adopts a like recommendation concerning guarantees of the third-party obligor's obligation to pay (see A/CN.9/631, recommendation 164). This rule applies to proceeds under an independent undertaking as well (see A/CN.9/631, recommendations 26, subpara. (b), 49, 105, 124 and 164).

3. Enforcement in the case of an outright transfer of a receivable

77. This Guide applies to outright transfers of receivables as well as security rights in receivables (see A/CN.9/631, recommendation 3). However, in an outright transfer, the assignor has generally transferred all of its rights in the receivable. Thus, the assignor has no continuing right in the receivable and no interest in the realization (usually collection) of the receivable. Accordingly, this chapter on

enforcement applies to the outright transfer of a receivable only when the assignee has some recourse to the assignor for the non-collection of the receivables. That is, it is only where the assignor may ultimately be liable to the assignee that it has an interest in the method of the collection or other disposition of the receivables (see A/CN.9/631, recommendation 162).

78. Recourse to the assignor for the non-collection of receivables that have been the subject of an outright transfer usually arises when the assignor has guaranteed some or all of the payment of the receivables by the debtor of the receivables. Recourse may also arise from other functionally equivalent arrangements, such as when (a) the assignor agrees to repurchase a receivable sold to the assignee if the debtor on the receivable fails to pay; or (b) the assignor merely agrees to pay any deficiency between the purchase price for the bulk sale of receivables and the actual collections on those receivables.

79. Recourse to the assignor for non-collection as used here refers only to non-collection because of the failure of the debtor of the receivable to pay for credit reasons (e.g. its financial inability to pay). Consequently, the failure of the debtor of the receivable to pay for tangible property or services because of their poor quality or the failure of the assignor to comply with its specifications for the property or services would not be considered as non-collection. Where non-payment arises for credit reasons, however, the normal rules for collection of receivables and enforcement of the security would apply (see A/CN.9/631, recommendations 163 and 164).

4. Enforcement of a security right in a negotiable instrument

80. In many States, it is possible to acquire a security right in a negotiable instrument (for the definition of “negotiable instrument”, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation), whether by taking possession or following other steps to achieve third-party effectiveness (see A/CN.9/631, recommendations 33 and 38). As a rule, even where there is a security right in the instrument, States defer to law governing negotiable instruments in determining the rights of persons obligated on the negotiable instrument and other persons claiming rights in the negotiable instrument (see A/CN.9/631, recommendation 121). These rights might include, for example, (a) the right of the person obligated on the negotiable instrument to refuse to pay anyone other than a holder or other person entitled to enforce the instrument under law governing negotiable instruments; and (b) the right of the person obligated on the instrument to raise certain defences to that obligation.

81. Where security is taken in a negotiable instrument, secured creditors will normally have possession or control of the instrument. Upon default of the grantor, many States permit the secured creditor to collect or otherwise enforce its security right in the instrument. This would include, for example, presenting it for payment, or, if default occurs before maturity, even selling it to a third party and using the proceeds to pay the grantor’s obligation. The rationale is that it would compromise the negotiability of the instrument if the secured creditor were obliged to go through the formalities required to exercise either the recourse of sale or taking the instrument in satisfaction of the secured obligation. Consistent with such practices, this Guide does not recommend that any further post-default formalities be imposed on enforcing secured creditors (see A/CN.9/631, recommendation 165).

82. As with receivables, it may be that the negotiable instrument is itself secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right in movable property of the debtor of the receivable). Many States provide for an automatic right of the secured creditor to enforce these other rights should the person obligated under the negotiable instrument fail to pay upon presentment. This Guide recommends such an approach to enforcement of guarantees relating to the payment of a negotiable instrument (see A/CN.9/631, recommendation 166).

5. Enforcement of a security right in a right to payment of funds credited to a bank account

83. Many States envision the possibility of creating a security right in a right to payment of funds credited to a bank account (for the definition of this term and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). In a bank account agreement, the bank is usually considered to be the debtor of the depositor and is obliged to pay the depositor a portion of or the whole amount on deposit when requested. Because banking law is closely tied to significant commercial practices within States, this Guide recommends deference to banking law and also provides additional safeguards for banks whose depositors may have granted security rights in their rights to payment of funds credited to a bank account (see A/CN.9/631, recommendations 33, 50, 101, 102, 122 and 123). For example, even if a depositor has concluded a security agreement with a creditor, the depositary bank has (a) the same rights and obligations in relation to its depositor; (b) the same rights of set-off; (c) no obligation to pay any person other than the person that has control of the account; and (d) no obligation to respond to any requests for information (see A/CN.9/631, recommendations 122 and 123).

84. Many States provide that, if the encumbered asset is a right to payment of funds credited to a bank account, the secured creditor may collect or otherwise enforce its right to payment of the funds after default or even before default if so agreed with the grantor. Enforcement would normally occur by the secured creditor asking the bank to transfer the funds to its own account, or otherwise to collect the sums credited to the account. The rationale for this rule is that the encumbered asset is the right to receive payment of the funds credited to the account and that it would be inefficient if the secured creditor were required to enforce by taking possession and following the steps applicable to the sale of encumbered assets or by taking them in satisfaction of the secured obligation. Consistent with the objective of enhancing flexibility and efficiency in enforcement, this Guide recommends that creditors enforcing security in a right to payment of funds credited to a bank account may do so by collecting the money in the account (see A/CN.9/631, recommendation 167).

85. Sometimes, States require the secured creditor to obtain a court order prior to enforcement of a security right in a right to payment of funds credited to a bank account. Such a requirement is understandable in situations where the secured creditor may have obtained third-party effectiveness through registration in the general security rights registry. However, where the bank is aware of the security right because it has entered into a control agreement with the secured creditor, requiring a court order would be an unnecessary formality. For this reason, this Guide recommends that, where a control agreement has been entered into, it is not

necessary to obtain a court order for the secured creditor to commence enforcement (see A/CN.9/631, recommendation 168). Conversely, where no such agreement has been entered into, this Guide recommends that a court order be required, unless the bank specifically consents to collection by the secured creditor (see A/CN.9/631, recommendation 169).

86. In many cases, the secured creditor will, in fact, be the depositary bank itself. Here, a formal enforcement process involving a specific act of collection and appropriation of the funds to repayment of the secured obligation would be superfluous. Upon default, a depositary bank acting as a secured creditor normally will deploy its right of set-off to apply the funds in the account directly to payment of the secured obligation in default. In keeping with this practice, this Guide recommends that enforcement of the depositary bank's rights of set-off not be affected by any security rights that the bank may have in the right to payment of funds in that account (see A/CN.9/631, recommendations 27 and 122, subpara. (b)).

6. Enforcement of a security right in proceeds under an independent undertaking

87. Today, some States permit persons that have the right to demand payment ("to draw") under an independent undertaking to grant security in the proceeds of that right (for the definition of this term and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). This Guide recommends that security rights may be created in such proceeds, subject to a series of rules governing the obligations between the guarantor/issuer, confirmer or nominated person and the secured creditor (see A/CN.9/631, recommendations 26, 28, 49 and 51). Because the law and commercial practices governing independent undertakings are quite specialized, this Guide recommends adoption of a number of rules meant to reflect existing law and practice (see A/CN.9/631, recommendations 124-126). So, for example, where the security right is automatically created, no separate act of transfer by the grantor should be necessary for the secured creditor to enforce a security right in a right to proceeds under an independent undertaking.

88. The general practice of States is to permit a secured creditor whose security right is in the proceeds under an independent undertaking to collect or otherwise enforce its right to payment of the proceeds after default or even before default if so agreed with the grantor. However, enforcement does not permit the secured creditor to demand payment from the guarantor/issuer, confirmer or nominated person (see A/CN.9/631, recommendation 28). Rather, enforcement would normally occur when the secured creditor indicates to the guarantor/issuer, confirmer or other nominated person that it is entitled to be paid whatever proceeds are otherwise due to the grantor. The rationale for this approach is that the guarantor/issuer, confirmer or other nominated person cannot be obliged towards anyone other than the beneficiary and only the beneficiary may request payment of the independent undertaking. This Guide follows the practice relating to independent undertakings and recommends that the enforcement of the security right be limited to collecting the proceeds once they have been paid (see A/CN.9/631, recommendation 170).

7. Enforcement of a security right in a negotiable document

89. Many States permit grantors to create security over a negotiable document (for the definition of this term and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). This Guide recommends a similar practice (see A/CN.9/631, recommendations 2, subpara. (a), and 29). The negotiable document itself represents the tangible property that is described in it and permits the holder of the document to claim that property from the issuer of the document. Normally, secured creditors will enforce their security right by presenting the document to the issuer and claiming the property. Special rules may, however, apply to preserve the rights of certain persons under the law governing negotiable documents and this Guide defers to these special rules (see A/CN.9/631, recommendation 127).

90. Nonetheless, as between the grantor and the secured creditor, enforcement will occur when the secured creditor presents the document to the issuer. At this point, the secured creditor will be in possession of tangible property and enforcement of the security right will then be subject to the normal principles recommended for the enforcement of security rights in negotiable documents or goods covered by them (see A/CN.9/631, recommendation 171). Depending on the agreement between the parties, either upon default or prior to default with the grantor's permission, the secured creditor may dispose of the document. This must be done in a commercially reasonable manner and the price obtained for the sale of the document will be applied to satisfaction of the secured obligation.

8. Enforcement of a security right in proceeds

91. In the normal course of a business operation, tangible property like inventory is meant to be sold. In any case, if the grantor sells the encumbered assets (in particular with the authorization of the secured creditor, in which case the security right does not continue in the encumbered assets; see A/CN.9/631, recommendation 86, subpara. (a)), the proceeds of the sale take the place of the encumbered assets (for the definition of "proceeds", see A/CN.9/631/Add.1, Introduction, sect. B. Terminology and rules of interpretation). Hence, many States provide that a security right in tangible property will automatically pass into the proceeds of its disposition. Other States either do not so provide, or require that the security agreement expressly indicate which proceeds will be covered by the security. This Guide recommends that secured creditors have a right to claim their security in proceeds of encumbered assets and proceeds of proceeds (see A/CN.9/631, recommendations 40 and 41). Moreover, unlike many States that limit the concept of proceeds to replacement property, this Guide considers proceeds to include anything that is received on account of the encumbered asset, any fruits and revenues it generates and the natural increase of animals or plants.

92. Generally, States do not enact separate rules governing the enforcement of security rights in proceeds. That is, enforcement against proceeds will follow whatever type of process is required in order to enforce security against that type of asset (e.g. a tangible property, a receivable, a negotiable instrument, rights to payment of funds credited to a bank account, and so on). It would create considerable confusion if secured creditors were able to enforce security rights in proceeds according to the rules governing enforcement against the initially encumbered assets when other creditors seeking to enforce security rights against

those proceeds as initially encumbered assets would have to follow rules specifically applicable to that type of asset. This Guide implicitly recommends that the general enforcement rules apply also to the enforcement of security rights in proceeds, except if the proceeds are receivables or other specific assets like those mentioned in the preceding paragraphs. In such a case, the asset-specific enforcement recommendations just described would apply.

[*Note to the Commission: The Commission may wish to consider adding a recommendation that specifically addresses enforcement against proceeds and that explicitly notes that where proceeds are of a special category of assets (like receivables) enforcement should follow the rules applicable to that category of asset.*]

9. Enforcement of a security right in an attachment to movable property, a mass or a product

93. Many types of tangible property in which a security right has been created are destined either to be attached to other tangible property, to be manufactured into a product or to be commingled with other tangible property. Many States deal with security rights in such cases by rules that determine whether ownership in the attachment, manufactured product or commingled property has passed to a third party. This Guide recommends that security rights that are effective against third parties generally should continue in property that has become attached to other property, into manufactured products and into commingled property (see A/CN.9/631, recommendations 35, subpara. (b), and 40-45). Where States permit continued third-party effectiveness of security rights in items of tangible property that are attachments, are manufactured products or commingled property, they normally also apply the general rules to enforcement against this type of property (e.g. automobile engines, manufactured fibreglass products, commingled inventories of clothing, grain in a silo and oil in a tank). The assumption is that it would create unnecessary confusion if an enforcement regime other than that generally applicable were to be enacted. The Guide implicitly adopts a similar rule for enforcement against security rights in attachments that are effective as against third parties.

[*Note to the Commission: The Commission may wish to consider adding a recommendation that specifically addresses enforcement of security rights in attachments.*]

94. In cases of attachment, manufacture and commingling, it will normally be the case that more than one secured creditor will have rights in the property. If the encumbered asset can be easily separated, the secured creditor with an enforceable security right against only a part of the property should be able to separate the part in which it has a security right and dispose of that part only in a commercially reasonable manner. If the encumbered asset cannot be easily separated, the whole asset may have to be sold and the rights of competing secured creditors that may have rights in the property to which the attachment is attached will be determined by recommendations relating to priority (see A/CN.9/631, recommendation 95). Similarly, if a proportionate share of commingled assets cannot easily be isolated for separate sale, the whole mass or product may have to be sold and the rights of competing secured creditors that may have rights in other parts of the commingled property will be determined by recommendations relating to priority (see A/CN.9/631, recommendations 96-98).

[*Note to the Commission: The Commission may wish to consider adding a recommendation that specifically addresses how enforcement of security rights in attachments and commingled property is to be effected depending on separability.*]

10. Intersection of movable and immovable property enforcement regimes

95. Frequently, the characterization of tangible property as movable or immovable will change over time, as movable property becomes immovable property. For example, construction materials may become fully incorporated into a building, or shrubs and trees, manure and seeds may be planted or tilled into soil, thereby turning into immovable property. Sometimes, the movable property may be an attachment and not fully incorporated into immovable property (for example, an elevator, a furnace, or an attached counter or display case). In all of these cases, a security right in the movable property may have been made effective against third parties prior to attachment to or incorporation into the immovable property. The converse situation can also arise. A creditor may seek to take a security right in property that is currently immovable, but is destined to become movable (for example, crops, products of mines and quarries and hydrocarbons).

96. States have enacted many different rules to govern these various hypotheses. A primary concern is to establish the rights of creditors that seek to enforce security rights in movable property where immovable and movable property enforcement regimes may intersect. Most often, these enforcement regimes depend on the characterization given to the property. So, for example, many States permit the creation of a security right under secured transactions laws (applicable to movable property) in movable property that, while it is part of immovable property, is destined to become movable, but postpone effectiveness until detachment. No enforcement of the security right can take place until the property becomes movable, and no enforcement of an encumbrance in immovable property may be taken against property that has become movable. While this Guide makes no specific recommendation on this question, because the enforcement regime presupposes the separate existence of tangible property as movable property such a result implicitly follows.

97. More difficult enforcement questions arise when tangible property is attached to or incorporated into immovable property. Many States distinguish between construction materials, other movable property that loses its identity when incorporated in immovable property (such as fertilizer), seeds, and attachments that retain their identity as movable property. Some States provide that security rights in movable property that loses its identity may only be preserved if they are made effective against third parties by registration in the immovable property registry, but that security rights in attachments made effective against third parties prior to the attachment retain their effectiveness without further registration. In these States, enforcement against the former kind of property would always be governed by the rules relating to enforcement against immovable property. Where the movable property becomes an attachment, these States usually enact special rules to govern not only the preservation of the secured creditor's rights, but also the preservation of the rights of creditors with rights in the immovable property.

98. The recommendations in this Guide follow the general pattern that many States have adopted for resolving conflicts between creditors with competing rights in attachments. Where tangible property loses its identity through incorporation into

immovable property, any movable property security right is extinguished. Where, however, the movable property becomes an attachment, the security right continues, and its effectiveness against third parties is preserved automatically. The secured creditor may also ensure third-party effectiveness by registration of the security right in the immovable property registry (see A/CN.9/631, recommendations 35, 42 and 43). The enforcement rights of the secured creditor as against the attachment, and in relation to secured creditors that may have security rights in the immovable property, will then depend on the relative priority of the competing rights (see A/CN.9/631, recommendations 93 and 94). If the secured creditor with rights in the attachment has priority, it may detach the property and enforce its security right as a movable security right, subject to the right of the secured creditor or other interested party paying the value of the attachment. If, however, detachment of an attachment to immovable property (e.g. an elevator from a building) damages the building (not by diminishing its value), the secured enforcing creditor has to compensate persons with rights in the immovable property. If another creditor with a security right in the immovable property has priority, the secured creditor can enforce its rights only under the regime governing security rights in immovable property, provided that it has maintained effectiveness against third parties by registering in the immovable property registry (see A/CN.9/631, recommendations 161, subpara. (a), and 172).

99. The enforcement of security rights in attachments to immovable property is further complicated where the secured creditor has taken an encumbrance in the immovable property and a security right in the movable property that has become an attachment to the immovable property. Most States enable the creditor in such cases to enforce the security in a variety of ways. The creditor may enforce the security right in the attachment and the encumbrance against the rest of the immovable property. Alternatively, the secured creditor may enforce the encumbrance against the entire immovable property, including the attachment. In the former case, the secured creditor would have to have priority over all rights in the immovable property (see A/CN.9/631, recommendation 172). In the latter case, the rights of the creditor would be determined by the priority regime governing immovable property (see A/CN.9/631, recommendation 161, subpara. (b)).

C. 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*.]