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Addendum

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A. General remarks

1. Introduction

(a) Meaning of acquisition financing transactions

1. The purchase and sale of tangible property (for the definition of "tangible property", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) is a central activity of many businesses. Sometimes, this involves the acquisition of raw materials and their subsequent manufacture and sale. Sometimes, it involves the purchase of inventory at wholesale for distribution to retailers or for resale at retail. In addition, for many businesses, the extraction and processing of raw materials or the display and distribution of inventory requires substantial investment in costly equipment. Most often these raw materials, inventory and equipment are purchased on credit.

2. Whenever a business acquires the ownership (or title) or the right to use, transform and dispose of raw materials, inventory or equipment on credit and offers rights in the property being acquired as security for the credit being extended, it is engaged in a particular form of secured transaction, which this Guide calls an acquisition financing transaction. The right that the seller or creditor retains or obtains in the property that is supplied to the buyer or grantor may be called, depending on their precise character, either "acquisition financing rights" or "acquisition security rights" (for the definitions of "grantor", "acquisition financing right" and "acquisition security right", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

3. Acquisition financing transactions are among the most important sources of credit for many businesses. In many respects, they are identical to ordinary secured transactions as described in previous sections of this Guide. But in other respects, they have particular features that have led States to provide for special rules in several situations. This chapter considers the ways in which States may achieve an efficient and effective regime to govern all types of acquisition financing transaction.

4. Because of the number and diversity of acquisition financing transactions in use today it is important to state clearly how this Guide uses the term. An acquisition financing transaction exists wherever one person may claim a property right in tangible property to secure another person's obligation to pay any unpaid portion of the purchase price (or its economic equivalent), whether that right exists in favour of a seller, a lessor or a lender. A transaction under which a seller retains property rights in the property sold for such a purpose is also an acquisition financing transaction. The key features of an acquisition financing transaction are two: (a) the credit is advanced for the specific purpose of enabling the buyer to acquire an item of tangible property; and (b) the acquisition financing rights retained or the acquisition security rights claimed relate directly to the property being acquired.

(b) Diversity of acquisition financing transactions

5. As noted in chapter III (Basic approaches to security) of this Guide, States have developed a wide variety of legal devices through which those that advance credit can ensure repayment of their debtor's obligation. While only some are classically known as security rights, all serve the economic function of securing the repayment obligation.

6. A similar, if not even greater, diversity of legal devices is typically available to those (often sellers) that finance a buyer's acquisition of tangible property. For example, a seller that retains title to the property being sold until the buyer has paid the purchase price in full (a retention-of-title seller), is extending credit terms to its buyer and is thereby financing the buyer's acquisition of that property. The retention-of-title right (for the definition of "retention-of-title right", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) is just one of several devices available to sellers. A seller may also transfer title to a buyer with a proviso that the buyer's title will be retroactively extinguished if it fails to pay the agreed purchase price (the sale is under a "resolutory condition"); or, a seller may transfer title to a buyer, but take a security right in the property being sold.

7. Sellers comprise just one category of financiers that may offer credit to enable a person to acquire a tangible object. Lenders also may provide credit to a buyer for the specific purpose of enabling that buyer to purchase property from a seller. Because both sellers and lenders may advance credit to enable buyers to acquire tangible objects it is possible for more than one person to be claiming an acquisition financing right or an acquisition security right in the same property.

8. Still another form of acquisition financing transaction may not even involve a contract of sale at all. A lessor that leases property to a lessee on terms that are equivalent to those of a sale on credit is likewise providing financing that enables the lessee to use the tangible property in the same manner as if it owned that property, even if title never passes from the lessor to the lessee. As in the case of sellers, there are different ways in which lessors may structure the agreement so as to create a financial lease, that is, a lease that enables the lessee to acquire the economic equivalent of an ownership right in the leased property (for the definition of "financial lease", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

9. So also, a lender that provides credit to a lessee for the purpose of paying the rental payments as they come due under a lease may, depending on the terms of the credit, be an acquisition secured creditor with rights in the property being leased. If the credit being extended actually enables the lessee to conclude the financial lease agreement with the lessor, the lender is financing the lessee's use (and notional acquisition) of that property.

(c) Outline of the chapter

10. This chapter discusses, in section A.2, the commercial background of contemporary acquisition financing transactions, and in section A.3, the various approaches to acquisition finance that have heretofore been adopted in different legal systems. Section A.4 sets out the key policy choices that confront States enacting legislation to govern the various types of acquisition financing transaction.

The remainder of the chapter then reviews how the several components of a secured transactions regime discussed in other chapters of this Guide apply in the specific case of acquisition finance. It considers, in section A.5, the creation of such devices as between the parties, in section A.6, the effectiveness of such devices as against third parties, in section A.7, priority as against competing claimants, in section A.8, pre-default right and obligations of the parties, in section A.9, post-default rights of the parties, in section A.10, private international law, and in section A.11, transition issues. The chapter concludes, in section B, with a series of specific recommendations.

2. Commercial background

(a) General

11. The opening paragraphs of this chapter summarized a number of different ways for a buyer to finance the acquisition of tangible property, such as equipment and inventory. In this section, the commercial background of these various transactions and their actual operation are considered in greater detail.

12. An initial distinction to be drawn when considering the purchase and sale of tangible property in a commercial setting is that between cash sales and sales on credit. Sometimes buyers have sufficient liquidity that they may purchase both equipment and inventory on a cash basis. As a rule, however, commercial enterprises will acquire a substantial part of their raw materials, inventory and equipment on credit.

13. Acquisition credit will normally be of two types. First, a buyer might simply borrow the purchase price from a third party on an unsecured basis. For example, while the sale transaction is itself a cash transaction, it may be financed by a general line of credit from the primary lender of the business. This method is simple, but the buyer's credit rating or reputation might limit availability of such credit or make the cost of such third-party credit prohibitively high. Second, a buyer may agree with a seller to purchase the property on credit terms that allow the buyer to make payment (perhaps in instalments) after the completion of the sale. Here the seller transfers possession and ownership of the property to the buyer and is paid the purchase price in a lump sum at a later time, or through periodic instalment payments. This method, of course, is not really different to third-party finance except that the risk of non-payment is now on the seller rather than on a third-party financier. Many sellers are often unwilling to bear such an unsecured risk.

14. As a result, many buyers find that, as a practical matter, it is necessary to give some form of security in order to acquire tangible property on credit. The property subject to a security right could well be other property of the buyer. For example, a business would grant security over its factory or warehouse to secure repayment of a loan to be used to acquire inventory or raw materials. Typically, however, the most obvious asset on which security may be taken, and frequently the only such asset available to a buyer, is the property actually being acquired.

15. Property being acquired can be used as security for acquisition credit in several different ways. For example, in some legal systems, sellers have special rights that automatically enable them to cancel the sale and take back the property sold if the buyer does not pay the purchase price within a certain period after delivery. Similarly, other legal systems give sellers an automatic right to claim a

priority or preference in the distribution of proceeds of a sale of the property they have sold. Often, however, the security claimed by an acquisition financier does not arise by operation of law, but is the result of an agreement between the seller or lender and the buyer.

16. The creation by agreement of a security right in property being acquired by a buyer in order to ensure the payment of the purchase price can take many forms. For example, the buyer may formally grant a security right in the property to a third-party financier; or the buyer may formally grant such a security right to the seller; or the buyer and seller may agree to some other legal mechanism, which, although not in the form of a security right, is its economic equivalent. Two such mechanisms are (a) the use of ownership in the property to secure payment (typically, although not always, by a retention-of-title transaction); and (b) the use of a longer-term lease (typically through a financial lease transaction).

(b) Retention-of-title and similar transactions

17. A supplier of inventory or equipment may wish to meet its customer's need for credit by supplying the property to the customer under an agreement by which ownership of the property being sold does not pass to the buyer until the purchase price has been paid in full. In many cases the agreement is between the seller and the buyer without any intermediary. In some cases, however, the seller may sell the property for cash to a finance institution or other lender, which may then sell the property to the buyer under an agreement that enables it to retain ownership of the property until full payment of the purchase price.

18. There are many forms in which buyers and sellers may structure an agreement by which the seller reserves ownership of the property sold until full payment (retention-of-title agreements). The retention-of-title mechanism is very common. In this transaction a seller's right in tangible property is not transferred to the buyer until the condition that the unpaid portion of the purchase price of the property is paid in full has been satisfied. While the buyer usually obtains immediate possession of the property, ownership remains vested in the seller until the purchase price is paid.

19. Retention-of-title arrangements are sometimes called conditional sales. Generally, however, in transactions called "conditional sales" the sale itself is not conditional (that is, the actual sale agreement is not dependent on the occurrence of some event not related to the sale itself). Rather, under a "conditional sale", it is the transfer of ownership to the buyer that is conditional. The seller reserves ownership of the property sold until the purchase price has been paid in full or the buyer has complied with any other conditions prescribed in the sale agreement.

20. There are, of course, other types of transaction whereby a seller uses ownership of the property sold as security for the purchase price. For example, sometimes the reservation of a seller's ownership is structured as a sale with a term, and the transfer occurs only at the end of the stipulated term. Occasionally, a seller will actually transfer ownership to a buyer at the moment of sale, with a proviso that the buyer's title will be retroactively extinguished should it fail to pay the agreed purchase price according to stipulated terms.

21. In each of these cases, the key feature is that the agreement by the seller to postpone full payment is protected either by delaying the passing of title to the

property to the buyer or, less commonly, by transferring title to the buyer subject to the seller's right to regain title upon failure of the buyer to pay. The more common case (retention-of-title transactions) may, in some States, be varied through certain clauses that greatly expand its usefulness as an acquisition financing device. So, for example, the parties may be permitted to agree to an "all-monies" or "current-account" clause. Where such clauses are used, the seller retains ownership of the property sold until all debts owing from the buyer to the seller have been discharged (and not just those arising from the particular contract of sale in question).

22. In addition, in some States parties are permitted to add "products" clauses, in which the seller's ownership is extended to, or the seller is deemed to have a security right in, any products that are manufactured from the property in which the seller retained ownership. Similarly, some States allow for "proceeds" (for the definition of "proceeds", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) clauses under which sellers may claim ownership or a security right in any proceeds generated by the sale of the property in which the seller retained ownership (for the treatment of proceeds in the case of ordinary security rights, see A/CN.9/631, recommendations 18-20).

23. Often, however, the applicable law strictly limits the scope of the seller's retained ownership. In many States the right may be claimed (a) only upon the property sold (i.e. neither on proceeds nor on replacement property); (b) only so long as the property remains in its original condition (i.e. unaltered by the manufacturing process); (c) only to secure the sale price of the property; or (d) only when all the three former conditions are met.

(c) Financial leases and hire-purchase transactions

24. A supplier may also use the concept of a lease to enable businesses to acquire the use of property without having to pay its purchase price in cash. For example, a supplier of equipment may lease a piece of equipment to a business that takes possession of the equipment and makes monthly rental payments. In these agreements the supplier necessarily retains ownership of the equipment (as lessor) and the lessee merely pays the rent as it falls due.

25. In some cases, the lease agreement is structured to achieve the functional equivalent of an instalment sale. For example, the term of the lease may be for the useful life of equipment being sold and, at the end of the lease, the lessee automatically acquires ownership; or the lease may be for the useful life of the equipment without the lessee having an obligation to purchase the equipment. Alternatively, the lease period could be for less than the useful life of the equipment but, at the end of the lease period, the lessee has the option to purchase the equipment at a nominal price. Given their economic purposes and effects, these various types of arrangements are often called financial leases (for the definition of "financial lease", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

26. Hire-purchase transactions are based on a similar principle. A typical transaction would commence with the lessee (hire-purchaser) selecting the equipment from the supplier (hire-seller) of the equipment. The lessee would then apply to a leasing company (usually a financial institution or an affiliate of one) to purchase the equipment from the supplier for cash and to lease it to the lessee

(hire-purchaser). As with an ordinary financial lease, very often the lease comprises the useful life of the equipment and, at the end of the lease period, the lessee automatically acquires ownership or has the option to purchase the equipment at the end of the lease period for a nominal sum.

27. Whether the financial lease agreement is a two-party arrangement between lessor and lessee or a three-party hire-purchase arrangement, the transaction takes the form of a lease. Nonetheless, the economic reality is that the lessee is paying the notional purchase price for the equipment in instalments, while the lessor remains the owner until full payment is made. Depending on the nature of the equipment at issue, lease periods may range from a few months to several years and items leased may range from high-value equipment, such as aircraft, to lower-value equipment, such as computers. Usually, the specific leasing arrangements are tailored to the lessee's unique cash-flow requirements, the tax regime in a State and other needs of the lessor and lessee.

(d) Seller-secured transactions

28. In many States today, a number of other legal devices are available to secure the performance of a buyer's payment obligations. As noted, some of these arise by operation of law. For example, in some States the seller of tangible property is given a high-ranking "privilege" or a "preferential claim" on the money generated by a sale in execution of the property it has sold. Whether the sale in execution is brought by the seller that has itself obtained a judgement against the buyer, by a judgement creditor of the buyer or by a secured creditor exercising a security right against the property, the seller may claim its statutory priority. What is more, this statutory preferential right is often given a rank that is superior even to that of consensual secured creditors.

29. In some States, a seller also has a right to refuse to deliver tangible property to a buyer that is not ready to pay the price at delivery. Occasionally, this right is projected forward as a reclamation right for a short period (e.g. 30 days) after delivery of the property. Neither of these rights is particularly effective as an acquisition financing right, however, since both typically presuppose that the sale is made for cash and not on credit.

30. More recently some States have also modified their law to permit a seller to take by agreement a non-possessory security right in the property sold. This type of seller's security right is usually available only in States that have also decided to permit lenders to take non-possessory security rights over tangible property. The seller's non-possessory security right is identical in form to the security right that an ordinary lender may take, but is given a special advantage. The seller that takes such a security is usually able to claim a preferred priority position that allows it to outrank any other secured creditor that is asserting rights granted by the buyer in that property.

(e) Lender acquisition financing

31. In many modern economies, lenders, rather than sellers and lessors, provide a substantial segment of the acquisition finance market. Historically, it was not possible for lenders directly to acquire any special priority rights in property for the acquisition of which they provided financing. Even where the money advanced to

the buyer was specifically intended to be used to purchase property and was in fact used for that purpose, the lender that took security in the property being acquired was considered to be a secured creditor subject to the priority rules governing security rights. That is, the lender that provided acquisition financing would rank lower that a pre-existing secured lender with a security right in a buyer's after-acquired property.

32. The only mechanism by which lenders could achieve the same preferred status as sellers and lessors was to acquire their rights. So, for example, where sellers retained ownership to secure the buyer's payment obligation, sometimes lenders would directly pay the purchase price to the seller and take an assignment of the seller's right to payment under the sale agreement, along with the seller's retention-of-title right. Similarly, in cases where the law enabled sellers to take by agreement a security right with a special priority status in the property being sold, the lender could purchase the seller's security right. Finally, in cases where the acquisition financing right arose by means of a financial lease, the lender would sometimes purchase the lease contract from the lessor. The particular form of transaction known as hire-purchase is a modern adaptation of this long-standing technique.

33. Today, however, many States permit lenders that advance credit to enable a debtor to purchase tangible property to acquire, in their own name, a preferential security right in those objects. In other words, in some States it is now possible for lenders to accede directly to a preferred status that was previously available to them only by purchasing the preferential right granted by a buyer to a seller. Nonetheless, in these States, not all lenders that provide money to a business that might ultimately be used to purchase tangible property will be able to claim an acquisition security right. The lender advancing the credit must do so to enable the purchaser to acquire the property, the credit must actually be used for that purpose and the right can only be claimed in the property thereby acquired.

34. Even though this special type of lender acquisition security right may be found in a number of States, the idea that a lender might be able directly to acquire a preferential security right in property the acquisition of which it specifically finances is not broadly accepted. Indeed, most States that permit sellers to secure the purchase price of the property they sell by means of a distinct reservation-of-title mechanism do not permit lenders to claim preferential acquisition security rights. Typically, only sellers themselves have the option of claiming such preferential acquisition security rights, which they may do as an alternative to retaining ownership.

3. Approaches to financing the acquisition of tangible property

(a) General

35. In the past, States have taken a wide variety of approaches to regulating acquisition financing transactions relating to tangible property. As noted, however, protecting the rights of sellers was typically conceived as the central objective. Moreover, until recently, in many States it was not possible to grant non-possessory security in tangible property, even to a seller. For these two reasons, the retention-of-title technique developed as an everyday practice in both civil-law and common-law systems. Sometimes States enacted legislation to acknowledge and regulate this acquisition financing technique. Most often, however, its development resulted from

changes in contractual practices relating to the sale of tangible property that were recognized and further elaborated by courts.

36. As an element of sales law that specifically touches the property aspects of the transaction, the conditions and effects of retention-of-title mechanisms vary widely from State to State. Many of these differences are products of history and the specific contractual practices that were adopted in response to the legal regime of individual States. The detailed configuration of many regimes, that is, does not result from a legislature comprehensively analysing the economic purposes served by secured transactions regimes generally or acquisition financing regimes in particular.

37. In some States, there is a real tension between the law of secured credit and existing business practices. Sometimes these business practices develop precisely to overcome existing legal rules. As such, often they are neither coherent with the legislative policy reflected by current law in a State, nor are they the kinds of practice that business would adopt if the legal regime were designed to promote efficient secured credit. Consequently, the law in this field of economic activity has frequently developed in a haphazard way. Novel contracts and additional terms to well-known types of agreement are invented in a piecemeal way as the need arises to serve as proxies for a fully developed regime to govern acquisition financing transactions.

(b) Approaches favouring seller-provided acquisition credit

38. In many States today, retention-of-title and economically equivalent devices available uniquely to sellers are the main or the only devices that provide acquisition-financing security while the buyer takes possession of the assets being purchased. Sometimes the regulation of sellers' rights is achieved by specifying a range of different legal devices within a civil or commercial code. Often, however, regulation results because particular sellers' rights are created in special statutes or by virtue of judge-made rules that deal with the various types of transactions that perform security functions whatever name they bear.

39. The approach that focuses on sellers as the principal source of acquisition finance is occasionally based on a policy decision to protect small- and medium-sized suppliers of tangible property on credit against large financing institutions. The approach acknowledges the importance of small- and medium-sized businesses (manufacturers and distributors) for the domestic economy and the dominant position of large financing institutions in credit markets. In these States, various assumptions are made to justify the policy affording special treatment for sellers that finance the acquisition of property by their buyers. One is that suppliers have an interest in providing credit at low rates to increase the volume of their sales. Another is that the cost of such credit is affordable because many suppliers do not charge interest prior to default. A third is that because there will usually be several suppliers seeking to sell property to the buyer, competitive prices will be offered to buyers.

40. A State considering secured transactions law reform needs to evaluate these assumptions carefully. While some assumptions may be justified, other assumptions may not be. For example, the fact that a supplier sells property to a buyer under a retention-of-title arrangement does not necessarily mean that the seller's credit

terms come at no cost to the buyer. The supplier itself has a cost of obtaining funds in order to extend these credit terms. In cases where interest is not charged till default, the supplier's cost of credit for itself will be embedded in the price of the property being sold.

41. Even if a State interested in promoting the manufacture and supply of tangible property wishes to encourage sellers to act as suppliers of credit, it need not do so to such an extent that other parties are excluded from offering competitive acquisition financing. In the same way that competition among sellers normally reduces prices for buyers, competition among suppliers of credit should reduce the cost of credit to borrowers. Fostering competition among all suppliers of credit will not only result in credit being available to the buyer at the most affordable rates, it is likely to open up other sources of credit enabling buyers to make payments to their sellers. In addition, making other sources of credit available to buyers will increase their capacity to purchase tangible property without the need for sellers themselves to provide financing to all their potential buyers.

42. Legal barriers that prevent financiers other than sellers and lessors from directly extending acquisition credit to buyers or that require these other financiers to extend credit only through the seller or lessor (by taking an assignment of the seller's retention-of-title claim or the lessor's lease agreement) are inefficient in other respects. Most importantly, treating acquisition financing simply as a matter of protecting the property rights of sellers and lessors can actually reduce the efficiency of the rights claimed by those sellers and lessors. Many modern secured transactions regimes offer secured creditors a number of rights that often have not, or not always, been available to sellers that deploy retention of title to secure their claims. These include, for example, automatic rights to claim security in any products that are manufactured from the property in which a security right is taken, or to claim a security right in any proceeds generated by the sale of the encumbered property, or to use the security right to secure all debts that may be owing from the buyer to the seller.

(c) Approaches promoting both seller- and lender-provided acquisition credit

43. In part to expand the range of those that may supply acquisition financing to a buyer, and in part to enable sellers to avail themselves of a full panoply of rights previously available to lenders that took regular security rights, many States today have redesigned their acquisition finance regime so as to promote both seller- and lender-based acquisition financing. Different approaches have been taken to achieve this law reform task.

44. In some States that maintain special acquisition rights for sellers based on a reservation of ownership, retention-of-title sellers are now able to expand their rights by contract through the insertion of, for example, proceeds clauses (often referred to as "extended retention-of-title" clauses) into the agreement of sale. Again, some States permit retention-of-title sellers to stipulate not only proceeds clauses, but also products clauses and all-sums clauses in order to enhance their rights. Finally, some legal systems recognize a buyer's expectancy right in property being acquired under a retention-of-title arrangement and permit the buyer to grant a lower-ranking security right in the property in favour of another creditor. Nonetheless, in most States that maintain special sellers' rights based on a reservation of ownership, only the simple retention-of-title is treated as a title

device, while these other more complex retention-of-title arrangements are either not recognized or are treated as giving rise to security rights.

45. Some States have reformed their secured transactions legislation to enable sellers to take preferential acquisition security rights, but still permit retention of title, financial leases and similar devices to co-exist as separate acquisition financing transactions. In these systems, the various devices by which ownership is deployed to secure a buyer's obligation are, however, typically regulated by substantially the same set of rules as those applicable to a seller's acquisition security rights. Still other States maintain traditional sellers' acquisition financing rights alongside sellers' acquisition security rights, but also allow lenders to claim security rights in the property being sold. To avoid the risk of imperfect coordination among various types of acquisition finance, these States often go further and integrate all acquisition financing transactions into the same framework of rules that governs security rights generally.

46. This last approach is based on a policy decision to treat, as far as possible, all transactions that are deployed to finance the acquisition of tangible objects equally. Creating equal opportunities for all credit providers, it is assumed, will enhance competition among them, thereby increasing the amount of credit available and reducing its cost. Nonetheless, States that continue to permit sellers to take security based on a reservation of ownership as well as acquisition security rights usually do not permit lenders that provide credit specifically to finance the acquisition of tangible property to accede to the preferred priority position of sellers and lessors. To do so, they must still purchase such preferred status from sellers or lessors. These types of modernized regime thus integrate sellers and lessors rights into the secured transactions regime and thereby facilitate financing on the security of the buyer's or lessor's expectancy, but do not permit these other financiers to compete directly for a first-ranking acquisition financing right in the property being purchased.

(d) Approaches based on the fully integrated "purchase-money" security right concept

47. Some States have taken a further step. Not only have they adopted an approach to acquisition financing that attempts to promote both seller and lender acquisition credit, but they have also enacted regimes that treat all providers of acquisition financing equally. In these regimes, lenders are enabled to take security in property being purchased, but also to acquire the same preferential status as sellers that take security rights in the property they sell. As a consequence, in these regimes acquisition security rights are made available equally to sellers, lessors, lenders and all other suppliers of acquisition financing. For regulatory purposes, the various acquisition financing rights of owners (retention of title, financial leases and similar devices) are (a) fully integrated into a single functional type of security right; and (b) treated identically to traditional acquisition security rights available to lenders. In many States that have adopted this approach, these various acquisition security rights are all characterized as "purchase-money" security rights.

48. Where the "purchase-money" security rights approach has been adopted two important principles govern its application. First is the idea that a purchase-money security right, which in this Guide is called an "acquisition security right", is a generic concept. That is, it is applicable to any transaction by which a financier

provides credit to enable a buyer to purchase tangible property and takes a right in the property being purchased to secure repayment of that credit. Second is the idea that a purchase-money security right is a species of security right. That is, except where the particular circumstances of acquisition financing require a special rule applicable to such rights, all the rules applicable to security rights generally also apply to acquisition security rights.

49. The following are the key features of an "acquisition security right" (using the terminology of the Guide) in States that have adopted the fully integrated, "purchase-money" security right approach:

(a) The right is available not only to suppliers of goods, but also to other providers of credit, including lenders and lessors;

(b) The acquisition secured creditor is given, for secured transactions purposes, a security right, regardless of whether that creditor retains title to the property being acquired;

(c) The buyer may offer a lower-ranking security right in the same property to other creditors and is thus able to utilize the full value of its assets to obtain credit, thereby enhancing mobilization of capital within the economy;

(d) The acquisition secured creditor, like other secured creditors, normally has to register a notice of its security right in a general security rights registry to establish priority over competing claimants and to provide third parties with a way of being informed that another creditor claims a security right in the same property;

(e) Once a notice of the security right is registered in the general security rights registry the security right is effective against third parties;

(f) If the notice is registered within a short period of time after delivery of the property to the buyer, the acquisition security right has priority over a holder of a judgement right or an insolvency administrator of the buyer between the time of the delivery of the property to the buyer and the registration of the notice;

(g) If the property is equipment and notice is registered within a short period of time after delivery of the equipment to the buyer, the acquisition security right has priority over the security right of a pre-existing secured creditor with a security right in future equipment of the buyer;

(h) If the property is inventory and, before the inventory is delivered to the buyer, the acquisition secured creditor registers the notice in the general security rights registry and also notifies a pre-existing secured creditor with a security right in future inventory of the buyer, for which a notice has been registered in the general security rights registry, that the acquisition secured creditor is claiming a higher-ranking acquisition security right in the inventory, the acquisition security right has priority over the security right of the pre-existing secured creditor; and

(i) The acquisition secured creditor that is a seller or a lessor may enforce its rights, within or outside insolvency proceedings, in the same way as any other secured creditor and has no other title-based enforcement rights.

50. Over the past few decades, several States have adopted this fully integrated approach to acquisition security rights. This trend may also be seen at the international level. For example, the International Institute for the Unification of

Private Law (Unidroit) Convention on International Interests in Mobile Equipment governs the effectiveness against third parties of retention-of-title and financial leases with separate but substantively similar rules to those regulating security rights. Accordingly, it extends the international registry contemplated by the Convention beyond security rights to retention-of-title and to financial leasing arrangements. Moreover, under the United Nations Convention on the Assignment of Receivables in International Trade,[1] the same rules apply to (a) security assignments; (b) outright assignments for security purposes; and (c) even pure outright assignments (see art. 2, subpara. (a)), thus avoiding drawing a distinction between security rights and title devices. Indeed, article 22 of the Convention expressly covers various priority conflicts, including a conflict between an assignee of receivables and a creditor of the assignor whose retention-of-title rights in property extends to the receivables from the sale of that property (for the definition of “priority” and “competing claimant”, see art. 5, subparas. (g) and (m), of the Convention). The same approach to acquisition financing rights is followed in the European Bank for Reconstruction and Development Model Law on Secured Transactions, the Organization of American States Model Inter-American Law on Secured Transactions and the Asian Development Bank’s *Guide to Movables Registries*.

4. Key policy choices

(a) General

51. Chapter III of this Guide reviews the basic approaches to security that might be adopted by a State considering secured transactions law reform in general. A key question addressed in the chapter is how to treat transactions that fulfil the economic function of secured transactions but are effectuated by deploying title to property to secure the full payment of the financier’s claim. This question arises in both non-insolvency and insolvency contexts.

52. Many States today continue to maintain a formal diversity of financing devices in all situations. That is, they recognize both security devices and traditional devices such as mortgages and sales with a right of redemption where lenders deploy a transfer of ownership of a borrower’s property to secure performance of an obligation. Other States maintain this formal diversity in non-insolvency situations, but under their insolvency regime characterize transactions where title is deployed to secure payment of a creditor’s claim as security devices. In these States, all transactions that fulfil the economic role of security are treated as functionally equivalent for insolvency purposes.

53. Other States have adopted this “functional equivalence” approach and extended it to non-insolvency as well as insolvency contexts. The regimes in these States recognize the specificity of these various types of device and continue to permit sellers to engage in retention-of-title or resolutory sale transactions, and continue to permit lenders to engage in mortgage transactions or sale transactions with a right of redemption. However, to ensure a proper coordination among these various transactions and to ensure as far as possible their equal treatment, these States subject all these transactions, however denominated, to a framework of rules that produces functionally equivalent outcomes. Finally, some States carry this logic

[1] United Nations publication, Sales No. E.04.V.14.

to its conclusion and adopt what might be called a “unitary” approach. Their secured transactions regime characterizes as security the various transactions fulfilling the economic function of security, regardless of their form, and explicitly denominates them as “security rights” (for the definition of “security right”, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

54. This Guide recommends that States adopt both a “functional equivalence” and a “unitary” approach to non-acquisition secured transactions generally. All transactions where rights in property, including ownership, are used to secure an ordinary repayment obligation by a borrower to a lender should be treated as security devices, and identified as such, in both insolvency and non-insolvency contexts (see A/CN.9/631, recommendation 11). The Guide calls this the “unitary and functional” approach. As explained in chapter III, the main advantages of the unitary and functional approach are two: (a) it more obviously promotes competition among credit providers based on price and thus is more likely to increase the availability of credit at lower cost; and (b) it better enables legislative policy decisions to be made on grounds of comparative efficiency.

55. This said, slightly different considerations arise when the obligation being secured is the payment of the purchase price of a tangible object (that is where an acquisition financing transaction is involved). The rationale for treating all lenders equally, regardless of the form of the credit transaction, does not automatically apply to situations of acquisition finance, since the parties involved are not just lenders. They are also sellers. In deciding whether to adopt the unitary and functional approach, therefore, States will have to determine (a) if the logic of secured transactions should override the logic of the law of sale and lease (or rather the logic of the law of ownership) when sellers and lessors use these transactions to secure the payment of the purchase price (or its economic equivalent) of tangible objects; or (b) if the logic of lease and sale should override the logic of secured transactions as the primary organizing principle in these cases.

(b) Functional equivalence: a generic concept of acquisition financing

56. In chapter III, this Guide notes that, while closely linked, the principles of “functional equivalence” and “unitary characterization” are independent. Equal opportunity to provide credit is the primary objective that States should seek to achieve when reforming their law of secured transactions both generally and in particular in relation to acquisition financing. The specific goals are two-fold: first, to ensure that, in so far as possible, all types of financiers are permitted to provide credit to enable business to acquire equipment and inventory; and second, to ensure that, in so far as possible, these various financiers will be subject to legal rules that treat them equally.

57. The idea of equal treatment of all financiers that provide acquisition credit is captured in the expression “functional equivalence”. There are reasons relating to both economic policy and the design of legal institutions why States might wish to adopt the functional equivalence principle. In market economies, creating equal opportunities for all credit providers will enhance competition among them, thereby increasing the amount of credit available and reducing its cost. There is no overriding reason of economic principle why the manufacturer or distributor of tangible objects should have a monopoly on providing credit to purchasers. Once it is accepted that financiers should be able to compete to offer buyers access to

acquisition credit, the legal regime under which they do so should not create incentives for one or another sub-group of financiers. The most efficient way to ensure that competition for the provision of credit is based solely on the terms and conditions offered by the financier is to establish legal rules that treat all of them in a functionally equivalent way.

58. In other words, buyers should be permitted to seek out the best deal possible to satisfy their acquisition credit needs. They should have equal opportunity to negotiate the term of the loan, the conditions of repayment, the interest charged, the events that would constitute a default and the scope of the security they provide with any potential financier. If the legal regime permits some financiers to obtain better security rights than others, this equality of opportunity to negotiate is compromised. In other words, from an economic perspective there is nothing unique about acquisition financing that would induce a State to take an approach to credit competition different from that it adopts in relation to ordinary non-acquisition financing.

59. There are also reasons relating to the design of legal institutions why a State might wish to adopt the functional equivalence principle. As noted, States have traditionally organized credit for buyers of tangible property by providing specific entitlements for sellers (the assumption being that sellers would provide most purchase-credit and most sales would be one-off transactions relating to individual items). Under such an assumption, the primary concern was simply to ensure that if the buyer did not pay the purchase price, the seller could recover the object sold quickly and efficiently and free of any third-party rights. That is, credit was simply an adjunct to the sale and the seller's primary interest was to receive value for the object provided to the buyer. Two developments required States to rethink this position.

60. First, as economies expanded, the need for acquisition credit grew and sellers found that they often could not meet all the credit needs of their buyers. Especially where manufacturers, wholesalers and retailers were purchasing large quantities of raw material and inventory, it became increasingly common for banks, finance companies and other lenders to extend credit to buyers for the express purpose of acquiring these raw materials and inventory. Second, the types of equipment needed for manufacturing and distribution became increasingly sophisticated and expensive. Moreover, often for tax reasons, buyers discovered that it was sometimes more economically advantageous to lease rather than purchase needed equipment. Frequently, these lease transactions were structured as the economic equivalent of a sale upon credit.

61. In both of these cases, a person other than the direct seller of the property provided acquisition credit to a buyer (or notional buyer). States were then confronted with having to decide whether continued reference to the seller's rights as the paradigmatic acquisition finance transaction was justifiable. The main reasons for concern lay in the fact that (a) sellers were traditionally able to get a top ranking secured right in the property sold based on their ownership, but other financiers such as lenders typically were not; and (b) when the transaction was structured as a lease rather than a sale in which the seller transferred title to the buyer against a right to have the sale set aside for non-payment of the purchase price, it was generally not possible for the lessee to deploy the leased asset as collateral to secure other credit. These concerns led States to consider whether a generic concept of an

acquisition financing transaction in which the fact that credit was being offered to a purchaser was the organizing principle might be a better way to organize this branch of secured transactions law.

62. Many States came to the conclusion that designing a legal regime in which all providers of acquisition credit would be able to exercise the same rights against a buyer-borrower in default would simplify this area of the law. That is, even when they decided that sellers should continue to be able to protect their rights by retaining ownership of the property sold until full payment by the purchaser, they concluded that the legal regime would be less uncertain and would generate less litigation if it did not draw purely formal distinctions between the rights available to different suppliers of acquisition credit. This led them to adopt the functional equivalence approach: all transactions being deployed to finance the acquisition of tangible property would be treated in essentially the same way regardless of their form and regardless of the legal status of the creditor (as seller, lessor or lender).

63. Consistent with the recommendation in chapter III (Basic approaches to security) of the Guide that States adopt the "functional equivalence" approach to non-acquisition secured transactions, in this chapter this Guide recommends that States adopt the principle of "functional equivalence" in respect of all acquisition financing transactions, however denominated (see A/CN.9/631, chapter XII, statements of purpose for unitary (sect. A) and non-unitary (sect. B) approaches; however under recommendation 174, alternative B for the non-unitary approach, there is no functional equivalence, and under recommendation 200 bis, subpara. (b), there is only qualified functional equivalence).

(c) Unitary and non-unitary approaches to functional equivalence

64. The second main policy choice that confronts States relates to the manner in which they design legislation to achieve functional equivalence. Once again, the main objective is to ensure that, in so far as possible, the legal regime that brings about this functional equivalence is crafted in a manner that facilitates the broadest extension of credit at the lowest price. This type of efficiency in a legal regime can be achieved in one of two ways. States may choose to collapse distinctions between various forms of acquisition financing transactions and adopt a single characterization of these devices. All acquisition financing transactions under the unitary approach will give rise to "acquisition security rights" and all financiers will be considered as "acquisition secured creditors" (for the definitions of "acquisition security right" and "acquisition financing right", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). This Guide refers to this method as the "unitary" approach.

65. Alternatively, States may choose to retain the form of existing transactions and the characterization given to their agreement by the parties (e.g. as sale, lease or loan) subject to the court declaring that characterization a sham. In doing so, however, they will nonetheless be required to adjust and streamline their technical rules for each transaction so as to promote functional equivalence and thereby to increase efficiency. This Guide calls this method for regulating acquisition credit the "non-unitary" approach. Acquisition financing transactions under the non-unitary approach will give rise either to "acquisition financing rights" in favour of an "acquisition financier" where a title device is deployed, or to "acquisition security rights" in favour of "acquisition secured creditors" if an ordinary security right is

created, whether in favour of a lender or a seller that transfers title to a buyer. The buyer or lessee of the property where a seller or lessor claims an acquisition financing right is described in this Guide as an "acquisition financing transferee" (for the definitions of the terms mentioned in this paragraph, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

66. The decision about which of these approaches to adopt is significant. It will affect the rights of third parties (both in and outside insolvency proceedings; however, the insolvency-related discussion is included in chapter XI) and, as a result, will have an impact on the availability and the cost of credit for buyers of tangible property. In addition, having decided to adopt one or the other of these approaches, States will also have to decide exactly how to design the particular rules by which all aspects of acquisition financing transactions will be governed.

67. When States adopt a unitary approach the consequences are two-fold. First, all acquisition financing devices, regardless of their form, will be considered as security devices generally subject to the same rules. This means that a creditor's rights in property under a retention-of-title sale, sale under resolutory condition, hire-purchase agreement, financial lease, or similar transaction will be considered to be an acquisition security right and be regulated by the same rules that would govern an acquisition security right granted to a lender. Second, the buyer in such cases will be considered to have acquired ownership of the property regardless of whether the seller purports to retain title by contract.

68. States may take one of two paths to enacting the unitary approach in cases where sellers deploy a title-retention device. They may provide that the buyer becomes owner for all purposes, with the result that States would explicitly have to amend other legislation (such as taxation statutes) if they desired that sellers in such transactions would be taxed as owners. Alternatively, they might provide that buyers become owners only for the purposes of secured transactions law and its related fields (debtor-creditor law and insolvency law in particular).

69. Because this Guide adopts a unitary approach to non-acquisition financing, it contemplates the possibility of a non-unitary approach only in respect of acquisition financing transactions. Nonetheless, even when States adopt a non-unitary approach, they should design the regime to reflect the functional equivalence principle (see A/CN.9/631, recommendation 184, non-unitary approach). For example, the regime should treat, in a functionally equivalent manner, sellers that retain title, sellers that do not retain title but retain a right to cancel the sale, sellers that do not retain title but take a regular acquisition security right in the property sold, lessors that retain title, and lenders that take a regular acquisition security right in the asset sold or leased.

70. In principle, States adopting a non-unitary but functionally equivalent approach could achieve functional equivalence between the rights of sellers that retain title and financial lessors on the one hand, and the rights of acquisition secured creditors on the other, in one of two ways. They could either (a) model the rights accorded to retention-of-title and similar claimants on those given to acquisition secured creditors that are not sellers or lessors; or (b) they could model the rights of these other acquisition secured creditors on the rights already available to retention-of-title creditors. In the former case, all acquisition financiers would be treated the same (as acquisition secured creditors), but acquisition financiers that

retain ownership would have slightly different rights from ordinary owners. In the latter case, all acquisition financiers and acquisition secured creditors would be treated the same (as acquisition financiers) but acquisition secured creditors and non-acquisition secured creditors would be subject to slightly different rules. While formally these may appear to be equally viable options, in view of the overall objective to enable parties to obtain secured credit in a simple and efficient manner, there are several reasons why the former approach to achieving functional equivalence in a non-unitary regime should be preferred.

71. One may begin with the objective being sought. The question is what approach is the most likely to achieve the most transparent and lowest cost credit regardless of the source of the credit. First, it would be quite complicated to design a set of rules that would turn lenders into owners (especially since lenders normally would have no expertise in selling or maintaining the assets the acquisition of which they are financing). Second, it would be quite complicated to design a set of rules that distinguish between the rights afforded to two classes of lenders, namely ordinary secured lenders and acquisition secured lenders. Third, it is much simpler to model the rights and obligations of a seller that benefits from an acquisition financing right, i.e. an acquisition financier (for example, in relation to the creation, effectiveness against third parties, priority over competing claimants and enforcement) on those of a seller or lender that benefits from an acquisition security right (an acquisition secured creditor). The reason is that this approach would enhance the overall coherence of the secured transactions regime, while enabling States to make adjustments necessary to maintain the coherence of their regime of ownership as reflected in the law of sale and lease. It follows that States that choose to adopt a non-unitary approach to acquisition financing transactions should seek to achieve “functional equivalence” by modelling the rights of acquisition financiers on the rights of acquisition secured creditors rather than the reverse.

72. In chapter III (Basic approaches to security), this Guide recommends that States adopt the unitary approach to non-acquisition secured transactions. Given this general orientation, this Guide suggests that, to the extent that they have the opportunity to do so, States should also adopt the unitary approach to achieving functional equivalence among acquisition financing mechanisms. Notwithstanding this suggestion, however, the Guide acknowledges that some States may feel the need to retain the form of title devices in relation to sellers and other suppliers. For this reason, in each of the subsections of this chapter the relevant issues are examined as they arise in contemporary legal systems, whether they follow the non-unitary or the unitary approach. Each subsection concludes with a review of how the law of acquisition financing could be best reformed if one or the other of these approaches were adopted.

73. In section B, moreover, this chapter contains two sets of parallel recommendations. One presents recommendations about how States should design the detail of a unitary and functional approach to acquisition financing transactions (and approaches it implicitly for States that are enacting legislation to govern the full range of secured transactions for the first time). The other deals with how States that elect to retain a non-unitary approach should design rules governing acquisition financing through title devices and, in particular, “retention-of-title” and “financial-lease” transactions, as well as “acquisition security rights”, so that the economic advantages of a unitary approach may be equally achieved under a non-unitary

approach (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

5. Creation (effectiveness as between the parties)

74. Chapter IV (Creation of a security right (effectiveness as between the parties)) of this Guide discusses the requirements for making a security right effective as between the parties. That chapter also uses the expression “creation” to characterize the requirements necessary to achieve effectiveness as between the parties. As explained in chapter IV, the underlying policy is to make the requirements for achieving effectiveness between the parties as simple as possible (see A/CN.9/631/Add.2, paras. […]). The precise manner in which these requirements may be transposed to regulating the effectiveness of the rights flowing from an acquisition financing transaction as between the parties will depend on whether a State adopts what has been called a “unitary” or a “non-unitary” approach.

75. Moreover, in States that continue to recognize retention-of-title transactions and financial leases as distinct transactions, it is not obvious that the word “creation” is the most appropriate one to describe the rights of the seller or the lessor. For example, the lessor’s ownership rights are not created separately from the contract of lease; they are a direct consequence of the lease itself: lessors are owners. Likewise, the seller that retains ownership is not creating a new right in its favour; it is merely continuing to assert the right of ownership it had prior to concluding the agreement with the purchaser. Nonetheless, for ease of expression the agreements under which a lessor and a seller may continue to assert their ownership against a lessee or purchaser to whom they have granted possession will sometimes be described as agreements “creating” the acquisition financing rights in question (it may be argued though that, in some States, in which the buyer acquires an expectancy of ownership, a new type of bifurcated ownership is created).

76. Legal systems in States that do not treat all acquisition financing transactions in the same way impose widely varying requirements for making acquisition rights effective as between the parties. To begin, the requirements imposed may vary within each State depending on the specific acquisition financing transaction (retention-of-title, financial lease, security right) in question. In addition, they can vary widely among States even in respect of the same type of acquisition financing transaction. That is, not all States conceive retention of title and financial leases identically and, therefore, not all impose the same requirement for creating or reserving such a right.

77. As an acquisition financing right, retention of title is usually seen as a property right that arises as an adjunct to a contract of sale. That is, in many systems, the formal requirements for the creation of a retention-of-title right (for the definition of this term, see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation) are those applicable to contracts of sale generally, with no particular additional formalities required. Hence, if a State accepts that a contract for the sale of tangible property may be concluded orally, the clause of the agreement providing that the seller retains ownership until full payment of the purchase price might also be oral. In such cases, the seller’s retention of title may be agreed to orally or by reference to correspondence between the parties, a purchase order or an invoice with printed general terms and conditions. These documents may not even bear the signature of the buyer, but the buyer may implicitly accept the terms and conditions

they set out through the taking of delivery of the property and payment of part of the purchase price as indicated, for example, in the purchase order or invoice. In other States, even though a regular contract of sale may be concluded orally, a writing (even minimal), a date certain, notarization, or even registration may be required for a retention-of-title clause in a contract of sale to be effective even as between the parties.

78. In some States, only the actual seller may benefit from a retention-of-title right and be required to follow the formalities associated therewith. Of course, credit providers that deploy financial leases, hire-purchase agreements and related transactions also retain ownership because of the nature of those contracts. The effectiveness of, for example, the lessor's right as between the parties will be dependent upon the parties complying with the ordinary formalities for third-party effectiveness applicable to the particular financial lease or hire-purchase agreement in question. Other suppliers of acquisition credit, such as lenders, may not directly obtain either a retention-of-title right or the ownership right of a financial lessor. Rather, to do so, they must receive an assignment of the outstanding balance of the purchase price from the seller or an assignment of the contract of lease from the lessor. Thus, the formalities for effectiveness of the right are, first, those applicable to the initial transaction with the purchaser or lessee, and second, those applicable to the assignment of that type of contract.

79. The various States that do not treat retention of title and financial leases as security rights also take differing approaches to the extension of these rights into other property. In some, if property subject to retention of title is commingled with other property, the retention of title is extinguished. In a few others, by contrast, the retention of title continues to be effective as between the parties without the need for the seller to undertake any further formality to preserve its right of ownership as long as similar property is found in the hands of the buyer. Similarly, in some systems, the retention of title is automatically preserved even if the property is processed into a new product, while in others retention of title cannot be extended to new products. Some States also permit lessors to continue to claim ownership of leased property that has been slightly modified, or depending on the terms of the lease, in the proceeds of an authorized disposition. In these cases as well, no additional formality to preserve effectiveness as between the parties is required.

80. There is a greater similarity in the principles governing the requirements for effectiveness of acquisition security rights as between the parties among States that have adopted a unitary approach. Indeed, almost no differences in these requirements may be found. Moreover, within each system, the formal requirements for making an acquisition security right effective as between the parties are identical regardless of whether the financing is provided by a seller, a financial lessor, a lender, or any other person. In addition, because acquisition secured credit is treated simply as a special category of secured financing (that is, because an acquisition security right is simply a species of security right), these formal requirements will be the same relatively minimal formalities as those required for non-acquisition secured transactions (e.g. a written and signed agreement identifying the parties and reasonably describing the assets sold and their price; see A/CN.9/631, recommendations 12-14). Finally, because the acquisition security right is a security right, it will be automatically preserved in manufactured property and in proceeds of disposition (see A/CN.9/631, recommendations 18-23).

81. The difference between the two approaches and among the specific legal systems described above rarely lies in a significant way in the written form requirement. That is, most of them would accept correspondence, an invoice, a purchase order or the like with general terms and conditions, whether they are in paper or electronic form. This is, moreover, the general position concerning a writing requirement that is suggested by this Guide (see A/CN.9/631, recommendations 9 and 10). The difference seems to lie more in the requirement of a signature, which may not be necessary as long as the retention-of-title seller, acquisition secured creditor or financial lessor is able to demonstrate by other evidence that the buyer or financial lessee has accepted the terms of the agreement. Such evidence could consist merely of the buyer's or financial lessee's acquisition and use of the property without protest after having received the writing. Thus, these minimal formal requirements are not burdensome. Also, because so many transactions for the purchase of tangible property are in fact well documented for other reasons, this issue rarely arises.

82. Under the unitary approach, the requirements for effectiveness as between the parties are the same as those applicable to non-acquisition security rights (see A/CN.9/631, recommendation 184, unitary approach), and are identical regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see A/CN.9/631, recommendation 185, unitary approach).

83. If a non-unitary approach were adopted, States seeking to achieve the benefits of a regime that created equal competition for credit would have to develop a regime that permits lenders to acquire the preferred status that is given to acquisition financiers. They would then also have to ensure that the rules governing effectiveness as between the parties bring about functionally equivalent results regardless of the form of the acquisition financing transaction (see A/CN.9/631, recommendation 184, non-unitary approach). In particular, the rules governing (a) the capacity of parties to the contract; (b) the specific character and modalities of the obligation secured; (c) the objects upon which the acquisition financing right might be taken; (d) evidentiary obligations such as a writing and signature; and (e) the time of effectiveness of the agreement between the parties; would have to be closely coordinated so as not to favour one type of acquisition financing transaction over another (see A/CN.9/631, recommendation 185, non-unitary approach).

6. Effectiveness against third parties

(a) General

84. Chapters IV (Creation of a security right (effectiveness as between the parties)) and V (Effectiveness of a security right against third parties) of this Guide draw a distinction between effectiveness of a security right as between the grantor and the secured creditor, and effectiveness of that right as against third parties. The point has a particular salience in relation to acquisition financing rights since, depending on whether a unitary or non-unitary approach is taken, the distinction between these types of effectiveness may not actually exist.

85. Most States that do not treat retention of title as a security right, with very few exceptions, do not require retention-of-title transactions to be registered. Neither do they require the seller to take any other formal step to ensure effectiveness as

against third parties. To the contrary, upon the seller and buyer concluding the agreement of sale with a retention-of-title clause, the seller's ownership right in the tangible property that has been sold is effective as against all parties.

86. By contrast, in some States registration of retention of title is required (either generally or for particular types of tangible property). In these States, it is often the case that registration is required only to make the retention of title by the seller effective as against third parties. Sometimes, however, no distinction is drawn between effectiveness of the retention of title as between the parties and its effectiveness as against third parties. That is, in some States registration of retention of title is viewed as a requirement for effectiveness even as between the parties.

87. Under any of these retention-of-title regimes, the seller that retains title has full ownership rights. As a consequence, it will usually be the case that the buyer has no rights in the property being purchased until title passes. This means that, except in those legal systems in which the buyer has an "expectancy right" to encumber, no other creditor of the buyer can claim rights in the property being purchased. This would be the case even if another creditor provided credit to the buyer to purchase the asset and the value of the buyer's assets subject to retention of title was higher than the amount of its obligations still owed to the seller. In such cases, the only property upon which the other creditor could claim security rights would be the contract of sale between the seller and the buyer. A result identical to this would also follow in the case of a financial lease. The sole property of the lessee upon which the creditor could claim security rights would be the contract of lease (assuming it were assignable).

88. Legal systems that do not recognize the right of a buyer that acquires property under a retention-of-title transaction or lessee under a financial lease to grant security over its expectancy right either prevent or make it difficult for borrowers to use the full value of either the equity they may have acquired in their tangible property subject to retention-of-title rights or the value of the financial lease contract. That is, the conceptual logic of a retention-of-title or a lease agreement disables the buyer from granting a non-possessory security right in the same assets to several creditors under a system that ranks those creditors in terms of priority for payment. Interestingly, however, in some of these same States, such a regime permitting multiple mortgagees with priority based on time of registration exists with respect to immovable property sold under a retention-of-title transaction.

89. In States that follow a unitary approach, retention of title and its economic equivalents are subject to registration of a notice in the general security rights registry (or to some other formality for making the right effective against third parties) in the same way as any other secured transaction. Under this approach, moreover, the right of the seller that retains ownership by contract or the lessor that remains owner by virtue of the nature of the lease is transformed into the right of an acquisition secured creditor. As a result, the buyer or lessee is able to use the equity it has in the property being purchased or leased as security for further credit. That is, buyers and lessees may grant security rights to other creditors in the same manner as they could were the seller to have sold the tangible property outright and simply taken its own security right in the property.

90. Under the unitary approach the requirements for third-party effectiveness are the same as those applicable to non-acquisition security rights and are identical

regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see A/CN.9/631, recommendation 186, unitary approach).

91. If a non-unitary approach were adopted, States would have to ensure that no substantial differences in requirements for third-party effectiveness exist between the different kinds of acquisition financing transactions (see A/CN.9/631, recommendation 186, non-unitary approach). A number of rules will have to be closely coordinated so as not to favour one form of transaction over another and, in particular, the rules governing (a) the modalities by which third-party effectiveness can be achieved; (b) the timing of third-party effectiveness when requirements are met; and (c) the consequences of third-party effectiveness on the right of the buyer or lessee to grant rights in the property. Specifically, in order to maximize the buyer's or lessee's capacity to benefit from the tangible property being acquired in the non-unitary approach, States would have to provide that, regardless of the acquisition financing transaction in question, the acquisition financing transferee (for the definition of this term, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) has the power to grant a security right in the property subject to the acquisition financing right (see A/CN.9/631, recommendation 185 bis, non-unitary approach).

(b) Third-party effectiveness of acquisition financing transactions relating to equipment and inventory

92. As noted in chapter V (Effectiveness of a security right against third parties), the general mechanism by which ordinary security rights may be effective against third parties is through registration (see A/CN.9/631, recommendation 33). As with ordinary security rights, the registration of a notice of an acquisition financing right or an acquisition security right is meant to provide a notice to third parties that such a right might exist and to serve as a basis for establishing priority between competing claimants. Registration promotes credit market competition by providing information that enables financiers to better assess their risks.

93. For this reason, the Guide recommends that third-party effectiveness of all types of acquisition financing transaction (whether denominated as security rights, retention of title, financial leases or in some other manner) usually be dependant on the registration of a notice in the general security rights registry. Where this Guide also recommends other mechanisms to achieve third-party effectiveness for ordinary secured transactions (e.g. possession and registration in a specialized registry) these mechanisms should also be available to acquisition financiers and acquisition secured creditors as alternative means to achieve third-party effectiveness (see A.CN.9/631, recommendation 186, unitary and non-unitary approach).

94. Under the unitary approach, coordination of registration of acquisition and non-acquisition security rights in the general security rights registry will be necessary to promote certainty in the relative priority of competing claimants. Under the non-unitary approach, the rules governing the registration of a notice with respect to different title devices will also have to be coordinated with the general rules relating to the registration of a notice with respect to secured transactions. Doing so (either by adjusting the former to cohere with the latter or adjusting the latter to cohere with the former, and by establishing a general security rights registry) will ensure certainty in the relative priority of competing claimants that

hold different types of acquisition financing rights. The principles that should govern priority conflicts under both unitary and non-unitary approaches, including priority conflicts where different methods for achieving third-party effectiveness have been used (see A/CN.9/631, recommendation 193, unitary and non-unitary approach), are discussed below in the section on priority.

(c) Grace period for the registration of certain acquisition financing transactions

95. Many States seek to enhance the efficiency of the registration process by providing sellers and other financiers with a short "grace period" (e.g. 20 or 30 days) after delivery of the property sold or leased to register a notice relating to certain acquisition financing transactions. Such grace periods are found both in States that do not consider retention-of-title, financial leases and other acquisition financing rights to be security rights and in systems that consider all such rights to be acquisition security rights. The use of the grace period permits delivery of the property without waiting until registration takes place.

96. Under the unitary approach, if the notice is registered within the grace period, the acquisition secured creditor has the same priority in relation to other claimants that it would have been able to assert had it registered at or before the time of delivery. If a State were to adopt a non-unitary approach, the same rules relating to a grace period for registration and its effects should apply to all acquisition financing rights regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. (see A/CN.9/631, recommendation 189, unitary and non-unitary approach).

(d) Exceptions to registration for consumer transactions

97. In some States where the registration of a notice relating to acquisition financing transactions would otherwise be required, an exception is made when those transactions relate to consumer goods (for the definition of this term, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). This means that the acquisition financing seller of tangible property bought for the buyer's personal, household or family purposes is not burdened with a requirement to register. Such transactions become effective against third parties at the same time that they become effective as between the parties. The idea is that in such cases the need to warn potential third-party financiers is less acute (unless consumers resell those goods), especially where the consumer goods are of low value. In other legal systems that generally require registration, only relatively low-value consumer transactions are exempted from the requirement to register (e.g. consumer transactions up to a maximum of euros 3,000 or its equivalent, or transactions that are subject to the jurisdiction of small-claims courts).

98. In both types of system, the significant market involving automobile finance credit to consumers is usually served by a system requiring not registration in the secured transactions registry, but rather a notice on a title certificate. Moreover, it is important to note that in States that create an exemption from registration for consumer goods, the exception applies only to consumer transactions. In other words, the exception does not apply to a type of property, but rather only to a type of transaction relating to that property. It is still necessary to register a notice to achieve third-party effectiveness in property normally sold to consumers if that property is being sold to a wholesaler or a retailer as inventory.

99. The exemption from registration does extend to equipment and inventory financing. Nonetheless, if a grace period were adopted for registering the notice of an acquisition financing transaction relating to equipment in the general security rights registry, that grace period may in itself serve as the equivalent of an exemption for short-term credit transactions fully paid within the grace period because, as a practical matter, the acquisition financier would not have to register before the expiry of that period. As for equipment-related acquisition financing transactions with longer repayment periods, and inventory-related transactions in general, an exemption may not be necessary if the acquisition financier could register a single notice in the secured transactions registry for a series of short-term transactions occurring over a longer period of time (e.g. five years) (see A/CN.9/631, recommendations 196 and 197, unitary and non-unitary approach).

100. Under the unitary approach, the exemption from registration for transactions relating to consumer goods would apply regardless of whether the acquisition secured creditor were a seller, lessor or lender since they would all be claiming identical rights. Were a non-unitary approach to be adopted, the rules relating to exemptions from registration for transactions relating to consumer goods should produce the same consequences regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the acquisition financing transaction (see A/CN.9/631, recommendation 187, unitary and non-unitary approach).

7. Priority as against the rights of competing claimants

(a) General

101. This Guide adopts the term priority to deal with competitions between all persons that may have rights in property subject to a security right (for the definition of the terms "priority" and "competing claimant", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). The concept of priority thus includes competitions both with (a) other creditors (secured creditors, other acquisition secured creditors, creditors that may avail themselves of a statutory preference and judgement creditors; and (b) other claimants (including prior owners, buyers and the insolvency administrator). Nevertheless, some States (and especially some States among those which do not consider retention-of-title and financial-lease rights to be acquisition security rights) adopt a more restrictive view of the notion of priority. Only competitions between creditors are considered to involve priority claims. This said, however the competition between various potential claimants is characterized, the relative rights of each must be carefully specified.

(b) Priority position of acquisition secured creditors and acquisition financiers

102. This Guide recommends in chapter IV (Creation of a security right (effectiveness between the parties)) that an ordinary security right may be taken in both present and after-acquired property (see A/CN.9/631, recommendation 12). It also recommends in chapter VII (Priority of a security right as against the rights of competing claimants) that priority generally be determined by the date of registration of a security right, even in relation to after-acquired property (see A/CN.9/631, recommendations 78 and 79). As a result, in order to promote the provision of new credit for the acquisition of additional property, it is necessary to

establish special priority rules applicable to competitions between acquisition financiers and acquisition secured creditors on the one hand, and pre-existing non-acquisition secured creditors holding rights in future assets of the grantor on the other.

103. In States that do not treat retention-of-title transactions and financial leases as security devices, the relative priority of claims is decided by reference to the seller or lessor's right of ownership. The retention-of-title seller or lessor effectively prevails with respect to the property sold over all other competing claimants (except certain bona fide buyers in an ordinary-course-of-business transaction). Moreover, in most such systems, until the buyer acquires title to the property, none of the buyer's other creditors may acquire any security rights in the property being purchased or subject to the lease. These other claimants whose rights in relation to the tangible property arise from a grant by the person acquiring it ("the acquisition financing transferee") generally cannot set up these rights against the retention-of-title seller or the financing lessor. While judgement creditors and the insolvency administrator may claim the buyer's contractual rights, unless the system permits the buyer to deal with its expectancy right, they cannot seize the property itself. For a similar reason, in cases of financial leases, neither could claim as against the actual property being leased. Finally, in most such States there can never be a competition between lenders claiming an acquisition financing right and a seller or lessor. First, it is rarely the case that the lender could acquire a right in the expectancy right of the buyer; and second, even if it could, the right would not normally be seen as an acquisition financing right. The only way in which a lender could acquire an acquisition financing right would be to purchase the rights of the seller or lessor.

104. In States that follow the unitary approach, the priority rights of a seller or a lessor that claims an acquisition financing right are equally protected. Provided that the retention-of-title seller, financial lessor or similar title claimant registers a notice in the general security rights registry within a short grace period and, in the case of inventory, takes certain other steps discussed below, they will have priority over all other claimants (except certain bona fide buyers in ordinary-course-of-business transactions). Moreover, under the unitary approach, a lender that provides financing to enable a buyer to purchase property will also be an acquisition secured creditor with priority over other claimants in the same manner as a seller or lessor. Finally, the retention-of-title seller, the financial lessor, or the seller that takes an ordinary acquisition security right, will have priority over any other acquisition financier in the same property, even if that other financier (e.g. a bank or other lender) had made its security effective against third parties before the seller did so. Thus, in States that follow the unitary approach the seller and lessor can achieve the same preferred priority position in relation to all other claimants as the retention-of-title seller or finance lessor in a non-unitary system.

105. While acquisition financing rights and acquisition security rights will normally be made effective against third parties by registration in the general security rights registry, in chapter V (Effectiveness of a security right against third parties) other methods for achieving third-party effectiveness are discussed. One of these, possession by the secured creditor, will generally produce the same consequences as registration, and may be looked upon as an alternative to registration. As a result, should an acquisition financier or an acquisition secured creditor make its rights

effective against third parties by possession within the stipulated grace period, the general priority principle would be applicable (see A/CN.9/631, recommendation 188, unitary and non-unitary approach).

106. Where the non-acquisition secured creditor makes its security right effective against third parties by registration in a specialized registry, chapter VII (Priority of a security right as against the rights of competing claimants) recommends that the registration in the specialized registry will give the registering creditor priority over even prior registrations in the general security rights registry or third-party effectiveness achieved by a prior possession (see A/CN.9/631, recommendation 83). In order to enhance the usefulness of the specialized registries, a similar rule should apply to acquisition financiers and acquisition secured creditors. They should not be able to obtain a preferred priority position simply by registration in the general security rights registry or possession within the grace period (see A/CN.9/631, recommendation 193, unitary and non-unitary approach). By implication, it would follow that, as a general principle, and subject to any superseding law, an acquisition financier or acquisition secured creditor that registered in the specialized registry would have priority over even a prior non-acquisition security right registered in that specialized registry.

107. Under the unitary approach, all acquisition secured creditors are subject to the same priority regime and must take identical steps in order to assure their priority position. The only difference between different categories of acquisition secured creditors is that in a competition between a seller or a lessor and another creditor all of whom are asserting an acquisition security right, the seller or lessor would always have priority, regardless of the respective dates of registration of their rights (see A/CN.9/631, recommendation 191, unitary approach).

108. If a non-unitary approach were adopted, to achieve functional equivalence States would likely have to make two changes to their existing regime. First, it would be necessary to permit financiers other than sellers or lessors that provide acquisition credit to acquire the preferred priority status of sellers and lessors by taking an acquisition security right. In such cases, it is important that equivalent rules relating to the priority of the seller's rights are established regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see A/CN.9/631, recommendation 188, non-unitary approach). Second, and concomitantly, in a competition between a retention-of-title seller, finance lessor or seller that takes an acquisition security right and an acquisition financier that is not a seller, it would be necessary to provide that priority goes to the seller or lessor, regardless of the date at which these various acquisition financing rights and acquisition security rights were registered (see A/CN.9/631, recommendation 191, non-unitary approach).

(c) Priority of acquisition security rights and acquisition financing rights as against pre-existing security rights in tangible property other than inventory or consumer goods

109. The general priority principles just noted establish a framework for organizing the rights of acquisition financiers and acquisition secured creditors, where more than one of them may be in competition over the same tangible object. But not all tangible objects serve the same economic purpose and are subject to the same business dealings. For this reason, it necessary to draw certain distinctions between

types of such property (notably, between equipment, inventory and consumer goods). The case of equipment is especially important.

110. As noted, in most States that do not consider retention-of-title and financial leases to be security rights, the issue of competition between acquisition financiers does not arise when the acquisition financing right is a retention-of-title or a financial lease right. Pre-existing non-acquisition secured creditors are rarely permitted to acquire rights in property of which the grantor is not yet owner, and other lenders are generally not entitled to claim a special priority when they finance a buyer's acquisition of tangible objects. Moreover, even if it were possible to take a security right in the expectancy of ownership, that expectancy will only mature once the seller or lessor is fully paid. Where, however, the seller itself takes an acquisition security right rather than retaining title, and is in competition with a pre-existing non-acquisition security right, it is necessary to provide for the priority of the seller's acquisition security right.

111. In States that follow a unitary approach the protection of the acquisition secured creditor's rights will have a common basis. Upon registration, before or within a grace period after delivery of the tangible property to the grantor, the acquisition security right in the new equipment is given priority over pre-existing security rights in future equipment of the grantor. Because the acquisition security right overcomes the general rule that fixes priority based on the time of registration, this preferred position of an acquisition security right is often referred to as a "super-priority".

112. Under the unitary approach, all acquisition secured creditors of equipment are able to claim a super-priority over non-acquisition secured creditors for their acquisition security right, provided that they register a notice indicating that they are claiming such a right in the general secured rights registry within the stipulated grace period (see A/CN.9/631, recommendation 189, unitary approach).

113. States that adopt a non-unitary approach would have to provide equivalent rules relating to the priority of the seller's or lessor's rights over pre-existing rights in future equipment regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. That is, even though the buyer is authorized to grant a security right in future equipment over which it will only have an expectancy right until the purchase price is fully paid or the financial lease concludes, and even if that security right over future equipment is made effective against third parties prior to the date of the sale, the retention-of-title seller (or similar acquisition financier) will have priority if it registers its rights within the same grace period given to any other acquisition financier (see A/CN.9/631, recommendation 189, non-unitary approach).

(d) Priority of acquisition security rights and acquisition financing rights as against pre-existing security rights in future inventory

114. Frequently, the competition between an acquisition financing right or an acquisition security right and a non-acquisition security right arises in relation to inventory. In such cases different policy considerations from those applicable to the acquisition of equipment are at issue. The reason for this is the following. Inventory financiers typically extend credit in reliance upon a pool of existing or future inventory on a short periodic and perhaps even daily or weekly basis. The pool of

inventory may be constantly changing as some inventory is sold and new inventory is manufactured or acquired. To obtain a new advance of inventory credit the grantor usually would present the lender with invoices or certifications indicating the actual status of the inventory serving as security for the new advance.

115. In States that do not treat retention-of-title transactions and financial leases as security devices, the relative priority of claims is decided by reference to the seller or lessor's right of ownership. For this reason the rights of the inventory financier are especially precarious and future advances will usually be made on the assumption that all new inventories are acquired under a retention-of-title transaction. It then becomes necessary for the creditor to determine what inventory has actually been fully paid. This has the effect of complicating a borrower's efforts to obtain future advances secured by the pool of inventory.

116. In States that follow the unitary approach the rights of the general inventory financier are more secure. Where the additional property acquired by the grantor is inventory, the acquisition security right will have priority over a non-acquisition security right in future inventory only if the registration of a notice in the general security rights registry is made prior to the delivery of the additional inventory to the grantor. In addition, in some States that follow the unitary approach, pre-existing inventory financiers that have registered their rights must be directly notified that a higher-ranking acquisition security right is being claimed in the additional inventory. The reason for this rule is that it would not be efficient to require the non-acquisition inventory financier to search the general security rights registry each time before advancing credit in reliance upon a pool of ever-changing inventory. To avoid placing an undue burden on acquisition secured creditors, however, a single, general notification to pre-existing non-acquisition inventory financiers on record may be effective for all shipments to the same buyer occurring during a significant period of time (e.g. five years or the same period that registration lasts to make a security right effective against third parties). This would mean that, once notification had been given to these pre-existing non-acquisition inventory financiers, it would not be necessary to give a new notification within the given time period for each of the multiple inventory transactions between the acquisition secured creditor and the party acquiring the inventory.

117. Under the unitary approach, acquisition secured creditors of inventory are able to claim a super-priority over non-acquisition inventory financiers for their acquisition security right provided that they register a notice indicating that they are claiming an acquisition security right in the general security rights registry and give a notice in writing to earlier registered non-acquisition financiers prior to the delivery of the inventory to the grantor (see A/CN.9/631, recommendation 192, unitary approach).

118. If a State were to adopt a non-unitary approach, equivalent rules relating to the priority of the seller's rights over pre-existing rights in future inventory should be established regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. That is, notwithstanding that the retention-of-title seller remains the owner of the property delivered, the rules governing the sale of inventory should be adjusted so that the seller's title will have priority over pre-existing rights in future inventory only under the same conditions as its rights would have priority were they to arise under an acquisition

security right taken by that seller (see A/CN.9/631, recommendation 192, non-unitary approach).

(e) Priority of acquisition security rights and acquisition financing rights as against pre-existing security rights in consumer goods

119. This Guide recommends, by exception to the general rule, that acquisition financing rights and acquisition security rights in consumer goods be effective as against third parties without registration in the general security rights registry or creditor possession (see A/CN.9/631, recommendation 187, unitary and non-unitary approach). In other words, in relation to consumer goods the priority of an acquisition financing right or an acquisition security right over a non-acquisition security right created by the acquisition financing transferee is acquired automatically from the moment the right becomes effective as between the parties.

120. Under the unitary approach, all acquisition financiers and acquisition secured creditors of consumer goods are able to claim a super-priority over non-acquisition secured creditors for their acquisition financing right or acquisition security right without the need to make the right effective against third parties by registration or possession (see A/CN.9/631, recommendation 190, unitary approach).

121. States that adopt a non-unitary approach would have to provide equivalent rules relating to the priority of the seller's or lessor's rights over pre-existing rights in consumer goods regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. This priority could, of course, find its source either in the seller's or lessor's ownership, or in the case of a seller or lender that takes an acquisition security right, in the general principle that applies to acquisition security rights in consumer goods (see A/CN.9/631, recommendation 190, non-unitary approach).

(f) Priority of acquisition security rights and acquisition financing rights as against the rights of judgement creditors

122. In chapter VII (Priority of a security as against the rights of competing claimants), this Guide recommends that judgement creditors that obtain a judgement and take the steps necessary to acquire rights in a judgement debtor's assets will generally have priority over existing secured creditors for advances made after they are informed of the judgement creditor's rights (see A/CN.9/631, recommendation 90). When the competing right in question is an acquisition financing right or an acquisition security right, a slightly different set of considerations, depending on the kind of tangible property at issue, must be taken into account. For example, if the tangible property is in the form of consumer goods, the acquisition financier or acquisition secured creditor is not required to register or take possession in order to make its rights effective against third parties. Hence the acquisition financier automatically benefits from a preferred priority position as against judgement creditors. If the property is inventory, the acquisition financier or acquisition secured creditor must have possession of the property, or have registered its rights and given a notice of its rights to already registered third parties prior to delivery. Hence the judgement creditor will always be on notice of the acquisition financier's or acquisition secured creditor's potential rights. In one case, however, the acquisition financier or acquisition secured creditor is given a grace period within which to register its rights. Nonetheless, it is rarely the case that

a person claiming an acquisition financing right or an acquisition security right will be making future advances.

123. This said, when a judgement creditor seeks to enforce its judgement against its debtor's property, it should not generally be able to defeat the rights of an acquisition financier or acquisition secured creditor that adds new value to the judgement debtor's estate. For this reason, if the unitary approach is adopted it should be provided that, as long as an acquisition secured creditor makes its rights effective against third parties within the grace period, it will have priority even over judgement creditors that register their judgement during that grace period (see A/CN.9/631, recommendation 194, unitary approach). If the non-unitary approach is adopted, a similar protection should be afforded to retention-of-title sellers and financial lessors and for financiers that have taken an acquisition security right (see A/CN.9/631, recommendation 194, non-unitary approach).

(g) Priority of acquisition security rights and acquisition financing rights in attachments and masses or products

124. This Guide recommends in chapter VII (Priority of a security right as against the rights of competing claimants) that a security right in an attachment to movable property that is made effective against third parties by registration in a specialized registry or by a notation on a title certificate has priority against a security right in the related property that is registered subsequently in the general security rights registry (see A/CN.9/631, recommendation 95). This recommendation rests on the fact that security rights that are effective against third parties remain effective even after the property that they encumber has become attached to other property. In such cases, if two or more security rights encumber the property at the moment of attachment, they would maintain their relative priority following attachment. In respect of a mass or product (or, in other words, commingled property), the Guide recommends that the security rights continue into the mass or product and if there are two or more, they retain their relative priority in the mass or product (see A/CN.9/631, recommendation 96).

125. In both situations, however, it is also necessary to determine the relative priority of rights taken in the different tangible property that is united by attachment or commingled. The Guide provides that the regular priority rules apply so that the date of registration in the general security rights registry would determine priority, unless one of the security rights was an acquisition security right. An acquisition security right taken in a part of commingled property would have priority over an earlier registered non-acquisition security right (and presumably even an acquisition security right) granted by the same grantor in the whole mass or product (see A/CN.9/631, recommendation 98). This Guide does not, however, take a position on whether an acquisition security right in an attachment should have priority over an earlier registered non-acquisition (or even acquisition) security right granted by the same grantor in the tangible property to which the attachment is attached.

126. In States that do not consider retention of title and financial leases as security devices, the general priority rules set out in chapter VII would not directly apply to acquisition financing. Chapter VII deals with situations where all forms of secured transaction are treated as security rights under the general unitary and functional approach. In the acquisition financing context, however, the relative rights of the parties depends on general rules governing attachments. Normally, if the attached

property can be detached without damaging the property to which it is attached, the retention-of-title seller would retain its ownership in the attachment. If the attachment could not be so removed, it is necessary to determine whether the attachment or the property to which it is attached is the more valuable. If the tangible property in which a seller has retained ownership is more valuable, the retention-of-title seller acquires ownership of the whole, subject only to an obligation to pay the value of the other property. If the tangible property in which a seller has retained ownership is less valuable, the retention-of-title seller loses its ownership and merely has a claim against the new owner for the value of its former property.

127. Under the unitary approach, acquisition secured creditors with rights in attachments and property that is commingled are generally able to claim a super-priority over non-acquisition inventory financiers. They will have priority over other secured creditors claiming a right in the attachment or in the tangible property that is being commingled or processed. They will also have priority over non-acquisition secured creditors of the property to which the attachment is attached, at least in so far as the value of the attachment is concerned, and they will have priority over non-acquisition secured creditors with security over the entire mass or product (see A/CN.9/631, recommendations 96-98).

128. If a State were to adopt a non-unitary approach, equivalent rules relating to the priority of the seller's rights over other rights in the attachment or the tangible movable property to be commingled or processed should be established regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction. That is, notwithstanding that the retention-of-title seller of an attachment might lose its ownership upon attachment, the seller should be able to claim its priority either in the share of the mass or product that it sold, or upon the attachment that it sold. The exact mechanism by which the rules of attachments to movable property would have to be adjusted depends on the detail of the law in each particular State that chooses to adopt the non-unitary approach.

(h) Priority of acquisition security rights and acquisition financing rights in attachments to immovable property

129. In chapter VII (Priority of a security right as against the rights of competing claimants), this Guide recommends that, after attachment, a security right in attachments to immovable property that is made effective against third parties under immovable property law has priority over a security right in those attachments made effective against third parties under the law relating to secured transactions. Conversely, if the security right in tangible property is made effective against third parties before attachment and is registered in the immovable registry it will have priority over subsequently registered security rights in the immovable property (see A/CN.9/631, recommendations 93 and 94). The logic of these provisions should also apply to acquisition financing rights and acquisition security rights.

130. The rights of an acquisition financier or acquisition secured creditor in tangible property that will become an attachment should have priority over existing encumbrances on the immovable property provided that it is registered in the immovable registry within a reasonable period after attachment. In this case, the person claiming an existing encumbrance on the immovable property made its advances on the basis of the value of the immovable property at the time of the

advances and has no pre-existing expectation that the attachment would be available to satisfy its claim. Of course, in cases where the pre-existing encumbrance on the immovable property secures a loan that is intended to finance construction, this same assumption would not hold, and the rationale for preserving the acquisition financier's or acquisition secured creditor's preferred priority is less compelling.

131. Under the unitary approach, a single rule governing these cases is possible since the claim of the acquisition secured creditor will always be a security right (see A/CN.9/631, recommendation 195, unitary approach). Should a State adopt the non-unitary approach, however, it will be necessary to adjust the rules relating to attachments to achieve a result that is functionally equivalent regardless of the form of the transaction. That is, it would be necessary to specify that the retention-of-title seller and the financial lessee will lose their priority to a construction financier even when the title to the property being attached does not automatically pass to the owner of the immovable property (as would be the case for property sold under retention of title or leased under a financial lease that is fully incorporated into the immovable property) (see A/CN.9/631, recommendation 195, non-unitary approach).

(i) Priority as between competing acquisition security rights and acquisition financing rights

132. In the various priority conflicts already described in this section, the competing claimants are asserting different rights in tangible property. That is, the conflicts are between the rights of an acquisition financier or acquisition secured creditor and a non-acquisition secured creditor, a judgement creditor or a creditor with security in immovable property asserting rights in an attachment. It may be, however, that the competition is between two claimants, each of whom is asserting rights arising from an acquisition financing transaction. There are various situations in which this may occur and the policy considerations that should bear on the resolution of such conflicts are complex.

133. In States that do not treat retention-of-title transactions and financial leases as security devices, the relative priority of claims is decided by reference to the seller's or lessor's right of ownership. Unless that system permits other creditors to take a security right in the expectancy right of the buyer, a competition between owners and secured creditors would not arise. Further, even if it were possible for a creditor to take a security right in a buyer's or lessee's expectancy right, that expectancy right will only mature once the seller or lessor is fully paid. In other words, in most such systems, there can never be a competition between lenders claiming rights under an acquisition financing transaction and a seller or lessor. The only way that a lender could acquire an acquisition financing right would be to obtain an assignment of the secured obligation from the retention-of-title seller or the financial lessor.

134. Furthermore, in States that do not treat retention-of-title transactions and financial leases as security devices, it is often possible for a seller (although not a lessor) to transfer title of the property being sold to the buyer and to take back a security right. Sometimes these seller's rights arise by operation of law (e.g. the vendor's privilege) but sometimes they also arise as a result of a security agreement between the seller and the buyer. In such cases, the buyer may well grant competing security rights in the property being acquired. These rights might be security rights granted and registered after the property has been purchased or beforehand, by

virtue of a security right covering present and future property. Nonetheless, even when the lender advances credit to enable the buyer to acquire the property, the security it takes in the property being acquired is invariably considered to be an ordinary security right. That is, in most States that do not treat retention-of-title transactions or financial leases as security devices it is not possible for lenders to directly accede to the preferred priority position that is given to a seller that takes an acquisition security right. This would be the case even where the buyer would obtain ownership from the seller and would grant the seller an acquisition security right in the property being purchased. Once again, in most such States, the only way that a lender could acquire the preferred priority afforded to an acquisition security right would be to obtain an assignment of the secured obligation from the seller that has taken such a security right for itself.

135. In States that follow the unitary approach, the priority rights of a seller and a lessor are protected because the rights they would otherwise claim are characterized as acquisition security rights and are given the same preferred priority position through the concepts of the "purchase-money security interest" super-priority. Such a preferred priority position is also afforded to sellers that simply take a security right in the property being supplied. In addition, and by exception to the situation that prevails in non-unitary systems, it is possible for lenders that advance money to borrowers so as to enable them to purchase tangible property to take a security right in the property being acquired that will be characterized as an acquisition security right. In other words, under the unitary approach, it is possible to have a genuine conflict between more than one acquisition security right.

136. Under the unitary approach followed in many jurisdictions, the law explicitly provides that in any competition between a seller that is claiming an acquisition security right and a lender that is also claiming an acquisition security right, the seller's acquisition security right will have priority regardless of the respective dates that these acquisition security rights were made effective against third parties. These unitary systems also provide that in a competition between two acquisition security rights taken by lenders, the date at which the right became effective against third parties will determine the relative priority of the two rights.

137. The policy decision that must be taken in States that choose to adopt a non-unitary approach is whether to permit financiers other than sellers or lessors to take security rights in property being acquired by their borrower that can achieve the preferred priority status of an acquisition security right. If not, there will never be a competition between two or more acquisition security rights or between an acquisition financing right and an acquisition security right. If so, States will also have to adopt a rule that provides for the priority of an acquisition financing right taken by a seller or a lessor or an acquisition security right taken by a seller over any other acquisition financing right or acquisition security right, whatever the respective date on which the seller's or lessor's rights became effective against third parties. Moreover, States will also be required to specify that, as between acquisition financing rights and acquisition security taken by financiers other than sellers or lessors, the priority of these rights will be determined by the date they became effective against third parties, regardless of the form of the transaction (see A/CN.9/631, recommendation 191, unitary and non-unitary approach).

138. There are several reasons why States that select a non-unitary approach might wish to permit lenders to accede to the status of acquisition secured creditors

directly (that is, without having to take an assignment of a seller's or lessor's ownership rights, or a seller's own acquisition security right). First, consistent with the overall objectives of this Guide, once it is accepted that a buyer may grant security in its expectancy right, there is no reason of principle to restrict this possibility to the grant of ordinary security. Second, and again consistent with the overall objectives of this Guide, permitting lender-provided acquisition financing credit will enhance competition for acquisition financing credit as between sellers and lessors and lenders (which should have a beneficial impact on the availability and the cost of credit). Third, without the possibility of lender-provided acquisition financing credit, lenders that wish to advance credit to their debtors-buyers against the expectancy right in property being acquired, will not have a preferred priority position as against other secured creditors on that expectancy right. They will simply rank according to the date their security became effective against third parties. That is, a later-in-time lender that wishes to advance credit specifically to enable a debtor to acquire tangible property will (in the absence of a subordination agreement) always rank after a general financier that has previously made its security effective against third parties.

(j) Multiple acquisition financing transactions

139. In many situations, a seller or other acquisition financier, or an acquisition secured creditor, will offer to provide financing to permit the acquisition of several assets. This could involve, for example, multiple sales with multiple deliveries of inventory, or multiple sales of several pieces of equipment. In these situations, it is necessary to decide, as a matter of policy, whether the acquisition financier or acquisition secured creditor benefits from its special priority rights over all equipment or inventory financed by it, without the need to identify the purchase price due under each particular sale. If so, the legal system in question is said to permit "cross-collateralization".

140. In States that do not treat retention-of-title transactions and financial leases as security devices, the issue of cross-collateralization usually does not arise. In the normal case of a retention-of-title or similar title transaction, the contract of sale or lease applies only to the specific assets sold or leased under that contract. Thus, while the same agreement may cover multiple deliveries, it would not cover multiple sales. The priority claim of the seller or lessee would relate to the specifics of each sale or lease. Some of these States do, however, permit the retention-of-title right to be extended by providing, for example, that the parties may agree to an "all monies" or "current account" clause where inventory is being sold. Where such clauses are used, the seller retains ownership of the property sold until all debts owing from the buyer to the seller have been discharged and not just those arising from the particular contract of sale in question (in some States though, retention-of-title sales with "all monies" or "current account" clauses are often characterized by courts as security devices).

141. In States that follow the unitary approach, the usual rule is that the super-priority of acquisition security rights, at least in inventory, is not impaired by cross-collateralization. This means that the acquisition secured creditor may claim its preferred priority position in relation to inventory for the acquisition of which it has provided the financing without being obliged to specifically link any outstanding indebtedness to any particular sale or lease transaction. Of course, in

such cases, the special priority right does not extend to other property, the acquisition of which was not financed by that acquisition secured creditor.

142. Under the unitary approach, the goal is to permit a maximum of flexibility to acquisition secured creditors that provide financing for the acquisition of inventory, and to minimize the transactional paperwork associated with multiple acquisition transactions involving the same acquisition secured creditor. The rule permitting cross-collateralization achieves this result (see A/CN.9/631, recommendations 196 and 197, unitary approach). Under a non-unitary approach, because a contract of sale or lease normally applies only to the specific assets sold, it would be necessary to modify the rules relating to retention-of-title sales and finance leases so as to permit cross-collateralization. Moreover, should a seller under the non-unitary approach or any acquisition secured creditor that is not a seller take an acquisition security right in the property sold, the seller or other financier should be enabled to exercise a right of cross-collateralization in the same manner as under the unitary regime (see A/CN.9/631, recommendations 196 and 197, non-unitary approach).

(k) Acquisition financing priority in proceeds of tangible property other than inventory or consumer goods

143. In many cases, the acquisition financier or acquisition secured creditor knows that the buyer will resell the property being acquired. This is obviously the case with inventory, but sometimes a manufacturer or other business enterprise will sell existing equipment in order to acquire upgraded equipment. As discussed in chapter IV (Creation of a security right (effectiveness as between the parties)), an ordinary security right in tangible property will normally extend into the proceeds of its disposition (see A/CN.9/631, recommendation 18). This extension of a security right into proceeds raises the policy question of whether the special acquisition finance priority should also extend to proceeds, and whether the rules for making such a claim should be the same regardless of whether equipment or inventory is being purchased.

144. In States that do not treat retention-of-title transactions and financial leases as security devices, the issue of a seller or lessor claiming special rights in proceeds generated by the sale of equipment often generally does not arise (see below for exceptions). This is because the law of sale or lease limits the seller's retained ownership right or the lessor's ownership only to the property sold or leased, and in the case of a sale only so long as this property remains in its original condition (i.e. unaltered by a manufacturing process or by customization). Of course, in cases of unauthorized disposition, the seller or lessor may be able to recover the property in kind from the person to whom it has been transferred. But sometimes the property cannot be found, although property or money received for its disposition can be identified. In addition, sometimes the seller or lessor permits the sale on condition that the seller's or lessor's title is extended to the proceeds and the products of the property in which the seller or lessor retained title. In these two situations, some States do permit the seller or lessor to claim ownership by real subrogation into the proceeds and products of the property sold under retention-of-title or leased. Where the contract is a sale, it is common to speak of the seller's rights as an "extended retention of title".

145. In some States that follow the unitary approach, the super-priority of an acquisition security right extends only to the property the acquisition of which is

financed, while in other States it may extend to its identifiable proceeds and products as well, at least in the case of transactions relating to equipment. Since the grantor does not usually acquire equipment with a view to immediate resale, there is little concern about prejudicing other secured creditors if the super-priority of an acquisition security right in equipment is extended to the proceeds of its disposition. If the equipment becomes obsolete or is no longer needed by the grantor, and is later sold or otherwise disposed of by the grantor, the secured creditor will often be approached by the grantor for a release of the security right to enable the grantor to dispose of the equipment free of the security right. Absent that release, the disposition would be subject to the security right and it would be unlikely that a buyer or other transferee would pay full value to acquire the equipment. In exchange for the release, the secured creditor will typically control the payment of the proceeds, for example by requiring that the proceeds of the disposition be paid directly to the secured creditor for application to the secured obligations. Under these circumstances, it is unlikely that another creditor would rely upon a security right taken directly in an asset of the grantor that is proceeds of the disposition of the equipment initially subject to an acquisition security right.

146. Under the unitary approach, the assumption is that the equipment is not normally subject to ongoing turnover. The acquisition secured creditor's control over the disposition of the asset supports the conclusion that the special priority afforded to acquisition secured creditors should be extended into proceeds of disposition and products of the property covered by the acquisition security right (see A/CN.9/631, recommendation 198, unitary approach).

147. If a State adopts a non-unitary approach, the rules relating to the maintenance of a special priority in proceeds of equipment should produce the same consequences as against other claimants regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the acquisition financing transaction. That is, the special priority of the retention-of-title seller or lessor of equipment should be claimable in the proceeds of disposition, either by continuing the seller's or lessor's title in the proceeds or by giving the seller or lessor the same priority claim as a seller that took an acquisition security right (see A/CN.9/631, recommendation 198, non-unitary approach).

(l) Acquisition financing priority in proceeds of inventory

148. The situation in relation to proceeds of inventory is different from that relating to proceeds of equipment for three reasons (each reason is equally applicable whether a non-unitary or unitary approach is adopted). First, inventory is expected to be sold in the ordinary course of business. Second, the proceeds of the sale of inventory will predominantly consist of receivables rather than some combination of a trade-in and receivables. That is, to take an example, it would not normally be the case that a seller of clothing or furniture would take back the purchaser's used clothing or furniture in partial payment of the purchase price. Third, it will often be the case that a pre-existing secured creditor, in extending working-capital credit to the grantor, will be advancing credit to the grantor on a periodic or even daily basis in reliance upon its superior security right in an ever-changing pool of existing and future receivables as original encumbered assets. It may not be possible or practical for the grantor to segregate the receivables that are the proceeds of the inventory subject to an acquisition financing right or an acquisition security right from other

receivables over which a pre-existing creditor has taken a security right. Even if it were possible or practical for the grantor to segregate the proceeds generated by the disposition of inventory over which an acquisition financing right or an acquisition security right had been granted, it would have to do so in a way that was transparent to both financiers and that minimized monitoring by both financiers.

149. Without such a prompt segregation that is transparent to both financiers and that minimizes monitoring, there is a significant risk that the pre-existing secured creditor extending credit against receivables would mistakenly assume that it had a higher-ranking security right in all of the grantor's receivables. There is likewise a risk of a dispute between the pre-existing secured creditor and the retention-of-title seller, purchase-money lender or financial lessor as to which financier has a priority right in which proceeds. All of those risks and any concomitant monitoring costs may result in the withholding of credit or charging for the credit at a higher cost. Of course, if the priority of the acquisition financing right or acquisition security right in the inventory does not extend to the receivables proceeds, the inventory acquisition financing creditor or acquisition secured creditor may itself withhold credit or offer credit only at a higher cost.

150. However, that risk may be ameliorated in a significant respect. For example, if the priority of the acquisition financing right or acquisition security right in the inventory does not extend to the receivables proceeds, a pre-existing secured creditor with a prior security right in future receivables of the grantor will be more likely to extend credit to the grantor in reliance upon its higher-ranking security right in the receivables to enable the grantor to pay for the inventory acquired by the grantor. The amount of the advance by the pre-existing secured creditor should be sufficient for the grantor to pay the purchase price to the seller of the inventory. This is because usually advance rates against receivables are much higher than those against inventory and because the amount of the receivables reflects a resale price for the purchase of the inventory well in excess of the cost of the inventory to the seller. Thus, there is a greater likelihood that the purchase price will be paid on a timely basis.

151. Under the unitary approach, the complexity of determining what receivables arise from the disposition of property over which an acquisition security right exists, and the widespread use of receivables as original property subject to a separate security right, are cogent reasons why the special priority afforded to acquisition security rights in inventory should be limited to proceeds of disposition other than receivables and other payment rights (see A/CN.9/631, recommendation 199, unitary approach).

152. Should a State adopt a non-unitary approach, the special priority given to acquisition financiers and acquisition secured creditors should not be extended to proceeds of disposition in the form of receivables and other payment rights regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the acquisition financing transaction. In particular, the special priority of the retention-of-title seller of inventory should be claimable by means of a real subrogation only into other tangible property, and not into proceeds of disposition of that inventory that take the form of receivables and other payment rights (see A/CN.9/631, recommendation 199, non-unitary approach).

8. Pre-default rights and obligations of the parties

153. As noted in chapter VIII (Rights and obligations of the parties), in most States there are very few mandatory rules setting out pre-default rights and obligations of the parties. The vast majority of applicable rules and principles are suppletive (non-mandatory) and may be freely derogated from by the parties. In addition, for the most part the pre-default rights and obligations of the parties will depend on how any particular State conceives the legal nature of the transaction by which an acquisition financing right or acquisition security right arises. In particular, the way in which these rights and obligations are cast will largely depend on whether the State in question adopts a unitary or a non-unitary approach to acquisition financing transactions.

154. In States that do not treat retention-of-title transactions and financial leases as security devices, the regime governing pre-default rights and obligations applicable to non-acquisition security rights cannot be simply transposed to acquisition financing rights. Of course, the rules applicable to non-acquisition security rights (whether taken by a seller or by a lender) can mirror those applicable to acquisition security rights. But where a title device (retention of title, financial lease or similar transaction) is at issue, it will be necessary to adjust the manner by which these rules are expressed.

155. Because the objective is to achieve functional equivalence among all acquisition financing transactions, this will often require reversing the default presumptions about the prerogatives of ownership. That is, normally it is the owner (the retention-of-title seller or the financial lessor) that has the right to use, and collect, the civil and natural fruits produced by an object. Normally it is the owner that bears the risk of loss and, therefore, has the primary obligation to care for the property, maintain it, keep it good repair and insure it. And normally, it is the owner that has the right to further encumber the object and to dispose of it. To achieve the desired functionally equivalent results, therefore, States will have to provide a mix of mandatory and non-mandatory rules vesting each of these prerogatives and these obligations in the buyer and not in the seller or lessor.

156. States that adopt the unitary approach need not attend directly to this issue since an acquisition security right is simply a species of security right. As such, it would only be necessary to apply the regular rules about pre-default rights and obligations to all acquisition financing transactions, regardless of the form of the transaction in question. That is, there is no reason to assume that obligations relating to use, the obligation to protect the value of the secured property, the collection of civil and natural fruits, the right to encumber, or the right to dispose should be any different simply because the security right at issue is an acquisition security right. If acquisition secured creditors and grantors wish to provide for a different allocation of rights and obligations, they should be permitted to do so within exactly the same framework as applicable to non-acquisition secured rights (see A/CN.9/631, recommendations 108 and 109).

157. Should a State adopt the non-unitary approach, the specific pre-default rights and obligations of the parties will have to be spelled out in greater detail in order to achieve functional equivalence. These rules will often have to be enacted as exceptions to the regular regime of property rights applicable to owners. Of course, as noted, most of the pre-default rules will not be mandatory. However, since the

non-mandatory default regime should establish a set of terms about pre-default rights and obligations that the legislature believes the parties would choose to most efficiently achieve the purpose of a security device, States that do adopt the non-unitary approach should ensure the enactment of non-mandatory rules that mirror those it enacts to govern acquisition security rights taken by sellers or lenders. So doing would have the additional advantage of clearly specifying the right of the buyer to grant security over its expectancy right, and confirming the buyer's right to use, transform or process the property in a reasonable manner consistent with its nature and purpose (see A/CN.9/631, recommendations 108 and 109).

9. Post-default rights of the parties

158. The discussion in chapter X (Post-default rights) illustrates that in most legal systems the rules relating to enforcement of post-default rights flow directly from the manner in which that legal system characterizes the substantive right in question. For example, many systems consider certain rights to be "property rights" and provide for special remedies to ensure their effective enforcement. Other rights are characterized as "personal rights" and are usually enforced by bringing an ordinary legal action against a person. In such systems, both the right of ownership and security rights in tangible property are seen as a species of "property right" enforceable through an in rem action (an "action against the property"). Although the specifics of enforcement of property rights through property actions can vary greatly depending on the particular property right enforced and the specific configuration of a State's procedural laws, for the most part these rules governing enforcement of post-default rights are mandatory. As such, they cannot be derogated from the parties to an acquisition financing right or an acquisition security right.

159. In States that do not treat retention-of-title transactions and financial leases as security devices, the procedure for enforcement of the seller's or the lessor's rights will normally be that open to any person that claims ownership in tangible property. So, for example, upon default by the buyer, the retention-of-title seller may terminate the sale agreement and demand return of the property as an owner. In that event, and subject to any term of the agreement to the contrary, the seller is normally also required to refund at least a part of the price paid by the buyer. This amount of the payment due by the seller is often calculated by requiring disgorgement of all money received from the buyer, minus the rental value of the property while in the possession of the buyer and the amount by which the value of property has decreased as a result of its use by the buyer, or damages determined under a similar formula.

160. In these States, a seller that terminates the sale is usually not obliged to account to the buyer for any of the profits made on any subsequent resale of the property but, at the same time, unless otherwise provided by contract, the seller has no claim against the buyer for any deficiency beyond any damages resulting from the buyer's breach of the original sales contract. In some legal systems, courts have also ruled in certain instances that there is an implied term in retention-of-title arrangements that the seller cannot repossess more of the property sold than is necessary to repay the outstanding balance of the purchase price. Finally, in most of these legal systems, neither the defaulting buyer nor any third party, such as a judgement creditor or a creditor that has taken security on the expectancy right of the buyer in the property being reclaimed by the seller, may require the seller to

abandon its right to recover the property. Because the seller is the owner of the property being reclaimed, it cannot be compelled to sell that property as if it were simply an acquisition secured creditor enforcing an acquisition security right.

161. The position of a seller that reclaims ownership and possession of property under a proviso that, having transferred ownership to the buyer, it may retroactively set aside the sale should the buyer not pay the purchase price as agreed (a resolutory condition) is similar to that of the retention-of-title seller. Upon default, the sale is terminated and the seller reacquires ownership, and may reclaim possession of the property as the owner. That is, once the resolutory condition takes effect, the rights and obligations of the seller that regains ownership are identical to those of the retention-of-title seller.

162. The situation of the financial lessor is normally slightly different. Since the form of the lease is such as to be a contract of continuing performance (the lessee has continuing possession and use while the lessor has a right to payment), under most legal systems, the lease contract will be terminated for the future only. This result means that the lessee will lose the right to purchase the property at the end of the lease (or to automatically acquire ownership if the contract so provides), and that the lessor will keep the full rental payments received. Subject to any contrary provision in the lease agreement, however, the financial lessor will not be able to claim for the normal depreciation of the property. Damages will be claimable only for waste or extraordinary depreciation. Moreover, financial lessors will not usually be able to claim for the difference between the amount they receive as lease payments and the depreciation of the leased property.

163. Under the unitary approach, the acquisition secured creditor may repossess the property, as would any other secured creditor. Whether the acquisition secured creditor is a seller, lessor or lender, it will be able, as outlined in chapter X (Post-default rights), either to sell the property, or if the grantor or other secured creditor do not object, to take the property in satisfaction of the secured obligation. In the former case, the enforcing creditor will be able to sell under judicial process or privately. Having sold the property, the secured creditor then has to return to the grantor any surplus on the resale of the property, but concomitantly has an unsecured claim for any deficiency after the sale (see A/CN.9/631, recommendation 200, unitary approach).

164. If a State adopts the non-unitary approach, several adjustments to existing rules relating to the enforcement of the ownership right of a retention-of-title seller or a financial lessor would have to be made in order to achieve equality of treatment among all acquisition financiers and between these acquisition financiers and acquisition secured creditors. These adjustments would include, for example, giving the buyer or lessee and any secured creditor with a right in the buyer's or lessor's expectancy right, the right to compel a seller or lessor to sell the property in which ostensibly it has a right of ownership, rather than simply assert that ownership right to regain possession of and ultimately to dispose of the property. That is, an acquisition secured creditor may propose to take the property in satisfaction of the buyer's outstanding obligation, but the buyer or other interested party may compel the acquisition secured creditor to sell the property instead. Achieving functional equivalence would mean that buyers and other interested parties would be enabled to compel the retention-of-title seller (an owner) to abandon the assertion of its right of ownership and to sell the property as if it were simply an acquisition secured

creditor. It would also require adjusting the seller's or lessor's rights so that they would be required to account for a surplus upon any sale in disposition, while at the same time permitting them to recover as simple contractual claimants for a deficiency without having to bring a separate action in damages.

165. Of course, deficiencies are much more common than surpluses. Still, requiring an acquisition financier to account to the buyer and other creditors with security in the expectation right of the buyer for any surplus upon enforcement will encourage those other creditors to monitor the enforcement process closely and thereby enhance the chances that the highest possible value will be achieved. Likewise, providing the creditor with a deficiency claim allows the creditor to enforce its full claim, which enhances the likelihood of complete repayment. A rule that would deny, absent a contractual term for damages, a deficiency claim to an acquisition financier (whether by retention of title or financial lease), when such a deficiency claim would be enforceable by a seller or lender that exercised an acquisition security right, would be unfair and inefficient. The rights of a seller, especially, should not be significantly different (either to the seller's advantage or to its disadvantage), depending only on whether it chose to retain title or to take an acquisition security right.

166. Arguably, either remedial scheme might be appropriate for a State to consider so long as the enforcement regime applied equally to retention-of-title sellers, financial lessors and acquisition secured creditors. In other words, as a matter of strict legal logic, it is possible to achieve functionally equivalent enforcement results regardless of whether a unitary or a non-unitary approach is adopted. The need for these several adjustments to existing retention-of-title and financial-lease regimes in order to achieve the full benefit of treating all sources of acquisition financing equally, as recommended in this Guide (see A/CN.9/631, recommendation 184, non-unitary approach), suggests that it may be preferable for States that have not already achieved this coordinated result through legislative, judicial or contractual adjustments to their rules governing retention-of-title transactions and financial leases to do so by adopting the unitary approach. Nonetheless, the non-unitary approach will, if implemented as recommended in this Guide (see A/CN.9/631, recommendations 200-200 tres, non-unitary approach), produce an efficient enforcement regime for acquisition financing transactions.[2]

10. Private international law

167. Many legal systems differentiate between rights of ownership and security rights in presenting rules relating to the applicable law. Under the unitary approach, whether an acquisition financing transaction involves a purported retention of title, a financial lease or an ordinary security right is immaterial. All will be considered as security rights and dealt with accordingly (see chapter XIII, Private international law).

168. Should a State decide to retain a non-unitary approach, however, it will face the question of whether the private international law rules applicable to the creation, third-party effectiveness, priority and enforcement of retention-of-title, financial

[2] The discussion of the treatment of acquisition security rights and acquisition financing rights in the case of insolvency is included in chapter XI (Insolvency) of this Guide, so as to ensure that all insolvency-related issues are contained in the same chapter.

leases and similar arrangements should be the same as those that apply to acquisition security rights or, more generally, to ordinary security rights that are taken in the same type of assets. The goal of achieving functional equivalence is a strong argument that States should characterize the ownership rights of acquisition financiers as acquisition security rights for private international law purposes (see chapter XIII, Private international law).

11. Transition

169. The rules regarding the treatment of what were previously non-security devices represent a significant change for most legal systems. In particular, the characterization of retention-of-title and financial leases (including hire-purchase agreements) as acquisition security rights will bring about an important modification to the scope of secured transactions law in legal systems that have not already adopted the unitary and functional approach to secured transactions generally. Chapter XIV (Transition) of the Guide discusses principles that should govern the transition to a new regime. In principle, the same principles should govern the transition in relation to acquisition financing rights and acquisition security rights as apply to the transition in relation to non-acquisition security rights.

170. With respect to retention-of-title devices and financial leases, a smooth transition depends on attending to the detail of the previous regime. If it were already obligatory for retention-of-title creditors and financial lessors to register their rights, then it would only be necessary to provide for a certain delay within which the registration would have to be renewed in the new general security rights registry. Alternatively, the law could provide that the existing registration would remain effective for a sufficiently long time (e.g. three to five years) to cover the life span of most retention-of-title or financial lease arrangements (see A/CN.9/631, recommendation 226).

171. If no registration is currently necessary, a smooth transition could be achieved if, consistent with the transition rules applicable to non-acquisition financing transactions, the effectiveness of the rights of retention-of-title sellers and finance lessors against third parties and their priority position are preserved by registering an appropriate notice in the security rights registry. Alternatively, the law could provide that the registration requirement would take effect at a date sufficiently far in the future after the new law comes into force (e.g. three to five years) that it would cover the life span of most retention-of-title arrangements existing at the time of the enactment of the law (see A/CN.9/631, recommendation 226).

172. Even should a State decide to adopt a non-unitary approach to acquisition financing transactions and to maintain retention-of-title and financial lease regimes, in order to establish an efficient secured transactions law, it will be necessary to reorder a number of rules relating to these transactions. Since the Guide recommends that they be registered in the general security rights registry, the same transition rules for registration applicable to the unitary approach could be adapted for the non-unitary approach. As for the substance of the law, similar adjustments would be necessary in order to produce outcomes that are functionally equivalent to those achieved under a unitary approach. In particular, it would be necessary to determine when the rules relating to the following issues will come into effect: (a) the priority of acquisition financing rights in proceeds; (b) the rights of third

parties to acquire security rights in assets subject to a retention-of-title or financial lease; and (c) the procedures for enforcing these types of acquisition financing device. While the scale and scope of the needed transition under the non-unitary approach might not be as great, the issues that arise in practice will be identical to those arising under the unitary approach and the general principles governing adoption of a unitary regime should also apply to the transition to a reformed non-unitary regime.

B. Recommendations

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