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Addendum

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X. Enforcement of a security right

A. General remarks

1. Introduction

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

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

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

assistance in developing a new business plan. In other cases, the grantor and an individual creditor, or the grantor and its whole group of creditors working together, may attempt informally to readjust aspects of their agreements.

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

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

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

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

8. This chapter examines the secured creditor's right to enforce its security right if the grantor fails to perform ("defaults on") the secured obligation. If the grantor is insolvent, insolvency law may limit the exercise of these rights (see chapter XIV, on the impact of insolvency on a security right). In section A.2 of the present chapter, the general principles guiding default and enforcement are discussed. Section A.3 reviews the procedural steps that a secured creditor may be required to follow prior to exercising its remedies and sets out the grantor's post-default rights. The different remedies typically available to secured creditors are examined in section A.4. In section A.5, the effects of enforcement on the grantor, the secured creditor and third parties are considered. The enforcement of a security right in proceeds is discussed

in section A.6. The intersection of the enforcement regimes relating to movable assets and immovable property is discussed in section A.7. Finally, the types of adjustment that may be necessary for effective enforcement against attachments to movable assets, masses and products are discussed in section A.8.

9. The enforcement of security rights in receivables, negotiable instruments, rights to payment of funds credited to a bank account, rights to receive the proceeds under an independent undertaking and negotiable documents does not fit easily into the general procedures for enforcement against tangible assets (for the definitions of those terms, see Introduction, section B, Terminology). As a result, many States have particular rules dealing with enforcement against intangible assets, receivables and various other rights to payment. These special situations are discussed in sections B.1-B.7 of this chapter. The chapter concludes, in section C, with a series of recommendations.

2. General principles of enforcement

(a) General

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

(b) Requirement of a default prior to enforcement

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

12. Occasionally, default occurs not because a payment has been missed, but because another creditor either seizes the encumbered assets under a judgement or seeks to enforce its own security right. Some States provide that, apart from any stipulation in the security agreement, the seizure of encumbered assets by any other creditor constitutes a default under all security agreements that encumber the seized

assets. The rationale is based on efficiency. As the encumbered asset is the creditor's guarantee of payment, whenever that asset is subject to judicial process, the secured creditor should be able to intervene to protect its rights. In these cases, procedural law will often give these other creditors the right to force the disposition of encumbered assets. The secured creditor will look to this same procedural law for rules on intervening in these judicial actions and enforcement proceedings in order to protect its rights and its priority.

13. Typically, States provide that a secured creditor with priority will be able to take over the enforcement process from a subordinate secured creditor should it so choose. This rule follows because the two secured creditors will be enforcing similar rights under the same security regime and the enforcement rights of these creditors should, therefore, be determined by their respective priority. Other States protect the rights of creditors with a higher priority ranking ("senior creditors") by providing that any realization sale by a creditor with a lower priority ranking (a "junior creditor") cannot affect the rights of a senior creditor.

14. In some States, once enforcement of a judgement claim has commenced, the secured creditor may not intervene to enforce its rights under the security agreement. This approach is usually followed in States where a judicial sale extinguishes all rights, including security rights, from the assets sold. The assumption is that because the judicial sale enables the purchaser to acquire a clean title, it will produce the highest enforcement value. In other States, however, where a secured creditor has rights in some or all of the assets under seizure by a judgement creditor, the secured creditor is permitted to counter the seizure and enforce its security rights by any means available to it. This approach is usually found in States where a regular judicial sale in execution does not extinguish security rights. The assumption is that since security rights will not be extinguished, a higher price of disposition is more likely to be realized when the enforcement process leads to the purchaser obtaining the cleanest title (see paras. 70 and 72 below).

(c) Good faith and commercial reasonableness

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

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

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

17. States that permit parties to waive their legal or contractual post-default rights by agreement nonetheless impose a number of restrictions on their capacity to do so. For example, they generally do not permit waiver of the creditor's obligation to act in good faith and in a reasonably commercial manner (see recommendation 129). As for other obligations, many States distinguish between the rights of the grantor and those of the secured creditor. In some States, the grantor may waive or agree to vary the secured creditor's post-default obligations only after a default has occurred. Allowing a waiver after default often enables the grantor and the secured creditor to "work out" in a non-adversarial way a disposition of the encumbered assets in a manner that maximizes the amount that can be realized for the benefit of the secured creditor, the grantor and the other creditors of the grantor (see recommendation 130). These same States usually also permit a secured creditor to waive its rights against the grantor at any time (either prior to or after default) on the assumption that there is little risk that abusive terms would be imposed by the grantor at the time the credit is being extended (see recommendation 131). In any case, a variation of rights by the parties to a security agreement does not affect the rights of third parties and any person challenging the agreement has the burden of proof (see recommendation 132).

(e) Judicial supervision of enforcement

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

19. The point is not to burden secured creditors with unnecessary judicial procedures, but rather to enable grantors and other interested parties to ensure

respect for mandatory post-default procedures (see recommendation 134). Consequently, to ensure that grantor challenges to enforcement can be dealt with in a time- and cost-efficient manner, many States replace the normal rules of civil procedure with expedited judicial proceedings in these cases (see recommendation 135). For example, grantors and other interested parties may be given only a limited time within which to make a claim or raise a defence. Other States permit grantors to challenge the secured creditor on these issues even after enforcement has commenced, or at the time proceeds of enforcement are distributed, or when the secured creditor seeks to collect any deficiency. Still other States permit grantors to obtain not only compensatory damages, but also punitive damages, should it be shown that the secured creditor either had no right to enforce, or enforced for an amount greater than that actually owed.

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

(f) Scope of post-default rights of the grantor

(i) General

21. As mentioned above, the grantor may seek court relief if the secured creditor fails to exercise its post-default rights in accordance with the security agreement and the law (see paras. 18-20). The grantor may also pay the secured obligation in full and obtain a release of the encumbered assets (see paras. 22-26 below). In addition, the grantor may propose to the secured creditor to take the encumbered assets in total or partial satisfaction of the secured obligation (or object to such a proposal of the secured creditor; see paras. 60-64), as well as exercise any other remedy provided for in the security agreement or the law (see recommendation 136). The grantor may also object to the extrajudicial taking of possession by the secured creditor or to the extrajudicial disposition of the encumbered assets (see recommendations 139, 144 and 145; see also paras. 29-32 and 48-56 below).

(ii) Extinction of the security right after full payment of the secured obligation

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

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

24. In addition, States usually take a flexible position in relation to the time within which repayment may be made. The secured creditor's interest is in being paid. As long as this payment of principal, interest and costs incurred for enforcement occurs before any third-party rights are affected, there is no reason for insisting on disposition of the encumbered asset. This means that, whoever exercises the right may do so up until the time of: (a) disposition of the encumbered asset or the completion of collection by the secured creditor after disposition of the encumbered asset; (b) the secured creditor entering into a commitment to dispose of the encumbered asset; or (c) acquisition by the secured creditor of the encumbered asset in total or partial satisfaction of the secured obligation, whichever occurs first. Until one of these events occurs, the secured obligation may be repaid in full and the encumbered assets released. For the same reasons (recognizing that the creditor's primary interest is in receiving payment and the grantor's primary interest is in not losing its assets), the Guide recommends that repayment leading to release of the encumbered assets be permitted right up until third-party rights are acquired, an agreement for the disposition of the assets has been concluded or the secured creditor has acquired the encumbered asset in satisfaction of the secured obligation (see recommendation 137).

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

26. States take quite different approaches to the reinstatement right. Some do not legislatively provide for a reinstatement right, but allow parties to provide for such a right in the security agreement. By contrast, some States provide that reinstatement is a right that may not be waived and may only be exercised by the grantor. Finally, some States permit any interested party to cure a default and reinstate the secured obligation. Whenever reinstatement is permitted, parties authorized to do so may exercise the right up to the same time that parties authorized to release the encumbered assets may exercise their right of release. As reinstatement maintains rather than extinguishes the secured obligation, the grantor may later again fall into

default. To prevent a series of strategic defaults and reinstatements, States that permit reinstatement usually limit the number of times that a secured obligation may be reinstated after default. The Guide does not contain a specific recommendation concerning reinstatement. The main reason for this approach is that the decision whether or not to permit acceleration clauses in security agreements (which would make the reinstatement right moot) is considered to be more properly a matter to be addressed by a State's general law of obligations.

(g) Scope of post-default rights of the secured creditor

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

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

(h) Judicial and extrajudicial enforcement

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

30. To facilitate secured transactions, some States require only a minimal prior intervention by public officials or authorities in the enforcement process. For example, the secured creditor may be required to apply to a court for an order of

repossession, which the court will issue without a hearing. In other cases, once the secured creditor is in possession of the asset, it may sell it directly without court intervention as long as it hires a certified bailiff to manage the process according to prescribed procedures. The justification for a less formal approach lies in the fact that having the secured creditor or a trusted third party take control and dispose of the assets will often be more flexible, quicker and less costly than a State-controlled process. A properly designed system can provide protection to the grantor and other persons with an interest in maximizing the amount that will be achieved from the sale of the encumbered assets while at the same time providing an efficient system for realizing on the encumbered assets. Moreover, the knowledge that judicial intervention is readily available is often sufficient to create incentives for cooperative and reasonable behaviour that obviates the need to actually resort to the courts. Finally, unlike the typical judgement creditor, most secured creditors are in the business of providing credit. Hence, reputation concerns will normally impose constraints on their enforcement behaviour.

31. In some States, the secured creditor is not required to use the courts or other governmental authorities for any enforcement purposes, but is entitled to make exclusive use of extrajudicial procedures. These States usually impose, in these cases, a number of mandatory rules relating to, for example, the obligation to send a notice of default or notice of intended disposition, the obligation to act in good faith and in a commercially reasonable manner, and the obligation to account to the grantor for the proceeds of disposition. In addition, they do not permit the secured creditor to take possession of the encumbered assets extrajudicially if such enforcement would result in a disturbance of the public order. The purpose and effect of these requirements is to provide for flexibility in the methods used to dispose of the encumbered assets so as to achieve an economically efficient enforcement process, while at the same time protecting the grantor and other interested parties against actions taken by the secured creditor that, in the commercial context, are not reasonable. This Guide recommends that, in order to maximize flexibility in enforcement and thereby to obtain the highest possible price upon disposition, creditors should have the option of proceeding either judicially or extrajudicially when enforcing their security rights (see recommendation 139). In any event, in States that permit extrajudicial enforcement, the courts are always available to ensure that legitimate claims and defences of the grantor and other parties with rights in the encumbered assets are recognized and protected (see recommendation 134).

32. Even in States where a secured creditor is permitted to act without official intervention, it is normally also entitled to enforce its security right through the courts. Moreover, because a security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation, post-default enforcement of the security right should not preclude a secured creditor from attempting to enforce the secured obligation by ordinary judicial process (see recommendation 141). There are a number of reasons why a secured creditor might choose either of these options over extrajudicial enforcement. The secured creditor may wish to avoid the risk of having its actions challenged after the fact, or it may conclude that it will have to apply for a judicial proceeding anyway in order to recover an anticipated deficiency, or it may fear a breach of the public order at the time of enforcement. Many States actually encourage secured creditors to use the courts by providing for less costly and more expeditious enforcement proceedings.

They may, for example, permit enforcement through a process involving only affidavit evidence. They may also provide for rules ensuring that the hearing must be held, challenges disposed of within a very short time period (e.g. 72 hours) and a decision rendered as expeditiously as possible. Some States even permit a secured creditor that has obtained judgement in the ordinary way to seize and dispose of the encumbered assets without having to use the official seizure and sale process. Finally, most States provide that these recourses are cumulative. A secured creditor that elects to pursue a particular extrajudicial remedy may change its mind and later pursue another extrajudicial remedy to enforce its security rights to the extent that the exercise of a right does not make the exercise of another right impossible (see recommendation 140 and paragraphs 33 and 34 below).

(i) Post-default rights cumulative

33. It will sometimes happen that, in order to dispose completely of all the encumbered assets, a creditor will be obliged to exercise more than one remedy. As noted, this typically occurs when a secured creditor liquidates a business. However, it may occur because, for example, security in inventory may be most effectively enforced through a sale, or security in equipment may be most efficiently enforced through the acquisition of the assets by the secured creditor in satisfaction of the secured obligation. In addition, there will occasionally be situations where a secured creditor believes that one remedy will be optimal, only to discover that another will generate a higher value upon disposition. This is why most States provide that a secured creditor's remedies are cumulative. This means that the enforcing creditor may not only have the option of selecting which remedy to pursue, it may exercise different remedies either at the same time or one after the other. It may even concurrently pursue both judicial and extrajudicial remedies. Only where the exercise of one remedy (e.g. repossession and disposition of an encumbered asset) makes it impossible to exercise another remedy (e.g. acquisition of an encumbered asset in satisfaction of the secured obligation) will the creditor not be able to cumulate remedies. Here also, the Guide adopts the policy that maximizing flexibility in enforcement is likely to ensure that the highest value is received for the encumbered assets and recommends that secured creditors be permitted to cumulate their judicial and extrajudicial remedies (see recommendation 140).

34. A security right is granted in order to enhance the likelihood of a creditor receiving payment of the secured obligation. The various post-default enforcement remedies, and especially extrajudicial remedies of the secured creditor, are meant to achieve this objective. Some States do not permit secured creditors to cumulate both their (judicial or extrajudicial) remedies with respect to the encumbered assets and their remedies with respect to the secured obligations. The assumption is that the extrajudicial remedies are a favour given to the secured creditor and that the creditor ought, therefore, to be required to opt either to enforce the security right extrajudicially or bring a judicial action to enforce the secured obligation. Other States permit the secured creditor to cumulate both its extrajudicial remedies and its right to enforce the obligation as a matter of contract law. Moreover, they permit the two proceedings to be brought concurrently or serially in either order. To require a secured creditor to opt, at the outset of enforcement, for one or the other mode of proceeding will complicate and increase the cost of enforcement because it will require a creditor to determine if a deficiency is likely to result. If the secured creditor comes to that conclusion, it will be obliged to bring an action to enforce the

obligation and assert its priority only at the moment of a judicial sale in enforcement. This process is less expeditious, more costly and will normally produce less value at the time of sale. To maximize enforcement value, the Guide recommends that secured creditors be permitted to cumulate proceedings to enforce the security extrajudicially and to enforce the secured obligation through a judicial process, subject always to the limitation that the secured creditor cannot claim more than it is owed (see recommendation 141).

(j) Right of the secured creditor with priority to take over enforcement

35. The secured creditor that has a higher priority will often wish to take over an enforcement process commenced by another creditor (whether this is under judgement enforcement proceedings or enforcement being pursued by another creditor exercising a security right). States usually provide for a takeover right from secured creditors enforcing under secured transactions law, but some do not permit secured creditors to pursue extrajudicial enforcement once a judgement creditor (whether an unsecured judgement creditor, or a secured creditor that may have also taken judicial enforcement proceedings) has seized the encumbered assets. Where a takeover right is given to a secured creditor against enforcement by a judgement creditor, States often require the secured creditor to exercise the right in a timely manner (i.e. before the auction begins) and to reimburse the judgement creditor for enforcement expenses incurred up to that moment. In order to maximize the efficiency of the enforcement of security rights, the Guide recommends that a secured creditor with a priority ranking higher than that of the enforcing secured creditor is entitled to take control of enforcement both against other secured creditors pursuing extrajudicial enforcement and as against judgement creditors (see recommendation 142).

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

(a) General

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

(b) Notice of intended extrajudicial enforcement

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

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

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

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

41. Regardless of which approach is taken, States must also decide what other notices may be required when a secured creditor seeks to enforce its security right extrajudicially. Many States that require a prior notice of intended disposition of the encumbered assets do not also require a separate notice of default or a subsequent notice of extrajudicial enforcement. The assumption is that a single notice will be sufficient for all purposes. Other States that permit the notice of the specific extrajudicial enforcement method being pursued to be given after the creditor obtains possession of the encumbered assets, nonetheless require a pre-possession formal notice of default. Because the objective and contents of the pre-possession notice of intention to enforce and the post-possession notice of extrajudicial enforcement largely overlap, no States that opt for the former also require the latter. To balance the interests of all parties, the Guide recommends that the secured creditor may take possession of the encumbered assets without applying to a court, provided that the grantor has consented to extrajudicial enforcement in the security agreement, does not object when the secured creditor seeks to obtain possession, and the secured creditor has given the grantor notice of default and of its intention to seek to obtain possession out of court (see recommendation 144).

(c) Form and content of the notice

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

43. States also take different approaches to the minimum content of the notice. As with the decision about the timing of the notice and its recipients, decisions about the information to be included require States to undertake a cost-benefit analysis. For example, they usually require the inclusion of the secured creditor's calculation of the amount owed as a consequence of default. They might further require advice

to the debtor or grantor regarding what steps to take to pay the secured obligation in full or, if such a right exists, to cure the default. Moreover, some States provide that the notice to other interested parties need not be as extensive or specific as notice to the debtor and grantor. Again, where the notice is to be given prior to taking possession, States sometimes place a higher information burden on secured creditors. Where the notice is given after possession, by contrast, the secured creditor is often obliged simply to provide basic information about the date, time, location and type of disposition being proposed and the time period within which the grantor or other interested party may contest the proposal or remedy the default.

44. There are different approaches to achieving the right balance between the need to ensure that the notice conveys to interested parties sufficient information to enable them to make an informed judgement about how best to protect their rights, and the need to achieve expeditious and low-cost enforcement. Some States place a heavy burden on secured creditors, both as to the timing and the content of the notice. Others impose only minimal requirements. The Guide recommends that this notice must be given prior to obtaining possession (see recommendation 144). If the secured creditor is already in possession, this notice need not be given. Nonetheless, in either case the creditor must inform the grantor of the intended manner of realizing upon the encumbered assets. If the proposed remedy is extrajudicial sale, the notice will be given, except in cases of urgency prior to disposition of the encumbered assets (see recommendation 146). While the secured transactions law should provide for the notice to be given in a timely, efficient and reliable way (see recommendation 147), the Guide recommends that States have the flexibility to determine the specific manner for giving the notice and its specific contents (see recommendation 147). In a like manner, the Guide recommends that, if the secured creditor exercises the remedy to acquire the encumbered asset in full or partial satisfaction of the debt (see recommendation 153), the notice must permit the grantor sufficient time to object to the proposal (see recommendation 154).

(d) Authorized disposition by the grantor

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

with the secured creditor in disposing of encumbered assets for the highest possible price; and (b) to give the secured creditor the incentive to seek the highest possible price even when this exceeds the amount still owing on the obligation secured by the encumbered asset.

4. Extrajudicial enforcement of the rights of the secured creditor

(a) General

46. In cases where a secured creditor elects to enforce the security agreement judicially, after judgement has been obtained, it will be necessary for the secured creditor to seize and sell the encumbered assets. In some States, the normal rules of civil procedure relating to the post-judgement enforcement process will apply. Typically, this means that public officials or authorities (e.g. bailiffs, sheriffs, notaries or the police) will take possession of the encumbered assets and sell them in a public auction. In other States, even after a secured creditor has obtained judgement, it may exercise its extrajudicial right to take possession of the encumbered assets and proceed to dispose of these assets extrajudicially. In still other States, once judgement has been obtained, the secured creditor must follow a judicial process, but a streamlined procedure for enforcing the judgement is provided.

47. Slightly different processes are required where a secured creditor has taken the steps that are necessary to commence enforcement proceedings and elects to proceed with extrajudicial enforcement. As no public official is involved, the secured creditor will normally wish to, and typically will have to, obtain possession or control of the encumbered asset itself in order to proceed with enforcement. States have taken different policy approaches both to the right of the secured creditor to obtain possession and control of assets (as opposed to consigning encumbered assets to a bailiff) and, if direct creditor possession is permitted, to the procedural mechanisms that must be followed for doing so.

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

48. Prior to default, the grantor will usually be in possession of the encumbered assets. Sometimes, however, the grantor will have already placed the secured creditor in possession, either at the time of making the security right effective between them (see recommendation 15) or thereafter either as a means of achieving third-party effectiveness (see recommendation 37) or in response to a later pre-default creditor request to take possession of the assets. On other occasions, the encumbered assets may be in the possession of a third party that is acting for, or under the direction of, the secured creditor. In both these situations, many States do not require the secured creditor to take any further steps in order to commence enforcement. That is, the creditor need not formally give the grantor notice of default, but need only send a notice of intended disposition once it has determined the recourse it intends to pursue. By contrast, some States require the creditor in possession to inform the grantor of the default and of the fact that it is now holding the encumbered assets in preparation for enforcement. These States usually also consider that, upon default, any agreement under which the creditor in possession may use the encumbered assets comes to an end.

49. Where the creditor is not in possession, it must take active steps to recover the encumbered assets from the grantor or to inform a third party holding on behalf of the grantor that the security right has become enforceable. States that provide for extrajudicial enforcement generally provide that, once a grantor is in default, the secured creditor has an automatic right to possession of the encumbered asset. This means that they do not require that, pending extrajudicial enforcement, the assets be placed under the control of a public official. The assumption is that flexibility in enforcement and preservation of the assets at a lower cost pending disposition will result if the secured creditor can make decisions about where post-default possession should lie. This rationale also underlies the recommendation in the Guide that the secured creditor has upon default an automatic right to possession (see recommendation 143).

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

51. States usually consider the taking of possession of encumbered assets by secured creditors to be a significant step in the enforcement process and impose specific procedural requirements on creditors claiming possession. This means that, even though the secured creditor may have an automatic right to possession, the manner for doing so is regulated. In general, States take one of three approaches in developing the procedural mechanisms by which secured creditors not in possession may take possession of encumbered assets. In some States, the secured creditor may only obtain possession by a court order, whether following an ex parte procedure, or more frequently, after a hearing. In other States, no judicial order is required, but the grantor must have authorized the creditor to obtain possession extrajudicially in the security agreement and the creditor must give the grantor a prior notice (typically 10 or 20 days) of its intention to claim possession and to enforce. Finally, in some States, the creditor is entitled to demand and to take possession without any recourse to a court and without the need to give the grantor a prior notice of its intention to do so, provided that the grantor authorized it to do so in the security agreement (see para. 38 above). Even in these States however, the creditor does not have an absolute right to obtain possession extrajudicially. There is always potential for the creditor abusing its rights by threatening the grantor, intimidation, breaching the peace or claiming the encumbered assets under false pretences. Most of these States, therefore, condition any acts of the creditor to obtain possession on the creditor avoiding a disturbance of the public order. Should the grantor resist, a judicial order for possession would be required. States that permit extrajudicial creditor possession upon the giving of a 10- or 20-day prior notice typically also

adopt this approach to possession and require a judicial order if a breach of the peace is threatened when the creditor seeks possession after the delay has expired.

52. As mentioned above (see paras. 39-41), in States that impose a notice requirement on secured creditors as a precondition to obtaining possession, there is always a risk that a grantor in default may then seek to hide or transfer the encumbered asset before the secured creditor can take control of it. It may also be that the assets may be misused, may dissipate if not looked after or, depending on market conditions, may rapidly decline in value. To forestall these possibilities, most States provide that secured creditors may obtain expedited relief from a court or other relevant authority. Furthermore, in the special case where the encumbered assets threaten to decline rapidly in value, and whether or not secured creditors are required to give a prior notice of their intention to enforce, many States permit the court to order the immediate sale of these perishable assets.

53. The decision as to the formalities required in order for a secured creditor to obtain possession depends on the balance States strike between the protection of the rights of grantors and efficient enforcement to reduce costs. It also depends on a judgement as to the likelihood in practice of abuse by secured creditors or improper behaviour by grantors in possession. In order to reduce the cost of enforcement and minimize the chances that assets will be misused or dissipate in value, the Guide recommends that the secured creditor be authorized to obtain possession extrajudicially, but only if the grantor has so consented in the security agreement, a notice of intention to take possession has been given to the grantor, and the grantor does not object at the time possession is being sought (see recommendation 144). In addition, the Guide recommends that notice of the creditor's intention to take possession and to dispose of the assets need not be given where assets are perishable or are likely to decline rapidly in value during the period between the giving of notice and the time when the creditor may actually obtain possession of the assets (see recommendation 146). However, for the secured creditor to have this remedy, the grantor must have authorized extrajudicial possession in the security agreement and have no objection when possession is actually being sought (see recommendation 144).

(c) Sale or other disposition of the encumbered assets

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

55. Most commonly, the procedural safeguards by which States control the actions of secured creditors relate to the details of the notice that must be given to the grantor and third parties with a right in the encumbered assets. In principle, the types of detail required should be identical whether States opt for a pre-possession notice approach or a post-possession notice approach. So, for example, States often require creditors to indicate the method of advertising a proposed disposition, the date, time and location of the sale, whether the sale will be by public auction or by tender, whether the assets will be sold individually, by lot or as a whole, and whether the disposition includes leases, licences or associated permits where required. The objective should be to maximize the amount realized for the encumbered assets, while not jeopardizing the legitimate claims and defences of the grantor and other persons. This explains why even States that generally require detailed notices do not do so when the encumbered assets are to be sold on a recognized public market. In such cases, the market sets the value of the assets and there is no higher price to be obtained by adopting and giving notice of some other mode of sale (see recommendation 146).

56. As an extrajudicial disposition of encumbered assets has the same finality as a court-supervised sale, most States not only impose relatively detailed rules as to the contents of the notice and the time that must elapse before the sale can take place, but also permit interested parties to object to the timing and manner of the proposed disposition. Typically, special expedited procedures are available so that objections may be quickly heard and dealt with (see recommendations 134 and 135). As a general rule, where the enforcing creditor has the greatest flexibility as to timing and method of disposition, the cost of enforcement is lowest, the enforcement is most expeditious and the proceeds received are highest. For these reasons, the Guide recommends flexibility for secured creditors and only the basic minimum of detail in the notice necessary to alert interested parties to the enforcement and the need to protect their interests should they wish (see recommendations 147 and 148).

(d) Allocation of proceeds of disposition

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

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

usually also prescribe if and when a secured creditor is responsible for distributing proceeds to some or all other creditors (such as secured creditors with security rights in the encumbered assets with a lower priority ranking than that of the enforcing secured creditor or, if the enforcement regime provides for a purge of rights, to secured creditors with a higher priority ranking and statutory priority claimants). Often, the secured creditor need only take account of these other rights if they are registered or have otherwise been made effective against third parties, or if it has been expressly notified of them (e.g. the case of statutory priority claims that need not be registered). Invariably States also provide that any surplus proceeds after all creditors entitled to payment have been satisfied are to be remitted to the grantor (see recommendation 149).

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

(e) Acquisition of the encumbered assets in satisfaction of the secured obligation

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

61. By contrast, in many States, the secured creditor is entitled to propose to the grantor that it acquire the encumbered assets in full or partial satisfaction of the secured obligation. Where such an enforcement remedy is made available to secured creditors, States usually provide that any agreement that automatically vests ownership of the encumbered assets in the secured creditor upon default is unenforceable if entered into prior to default. However, the agreement is enforceable if made after default and according to the specific enforcement procedures meant to prevent creditor abuse. These States usually also provide that any informal private agreements entered into by grantors and secured creditors after

default are enforceable, but only as contractual payment remedies that have no effect on third parties with rights in the encumbered assets.

62. Where States expressly permit the creditor to take the encumbered assets in satisfaction of the secured obligation after default, provided that it has followed the required procedural steps, this does not mean that the grantor must accept the secured creditor's offer. The grantor may refuse to do so, with the consequence that the secured creditor will have to pursue one of its other remedies. The advantage of permitting these types of post-default agreement is that they can often lead to less expensive and more expeditious enforcement. The disadvantage is that there may be a risk of abuse by the secured creditor in cases where: (a) the encumbered assets are more valuable than the secured obligation; (b) the secured creditor has, even in the post-default situation, unusual power over the grantor; or (c) the secured creditor and the grantor come to an arrangement that unreasonably prejudices the rights of third persons with a right in the encumbered assets.

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

64. Whether States should impose any or all of these requirements, and especially the requirement of prior judicial involvement, will depend on their assessment of the costs and benefits of each requirement. In line with the general objective of maximizing flexibility so as to obtain the highest possible value for encumbered assets at the point of enforcement, the Guide recommends that either the secured creditor or the grantor may propose to the other that the assets be taken in satisfaction of the secured obligation (see recommendations 153 and 156). Likewise, to ensure that all parties understand the full implications of the proposal, the Guide recommends that adequate notice of the secured creditor's intention to acquire the assets in payment is given to the grantor and third parties, and that the notice indicates not only the assets to be taken in satisfaction, but also the amount owed at the time the notice is sent, the amount of that obligation that is proposed to be satisfied by the acquisition, and a relatively short period of time at the expiration of which the proposal will be deemed to be accepted by the grantor and third parties (see recommendation 154). The assumption is that requiring the secured creditor to indicate its own valuation of the encumbered assets is a more efficient and less costly mechanism for providing relevant information to interested parties than providing for an independent appraisal. It is also assumed that, once informed of the secured creditor's proposal, the grantor or third parties will be in a position to assess its reasonableness. This is the reason why the Guide further recommends that the grantor or third parties be given a right to object to the secured creditor's acquisition of the encumbered assets. The consequence of a timely objection is that the secured

creditor must abandon this remedy and exercise another of its remedies, i.e. typically an extrajudicial sale or other disposition (see recommendation 155).

(f) Management and sale of a business

65. In many circumstances, a secured creditor has security not just on specific assets of a grantor, but on most or all of the assets of a business. In these situations, the highest enforcement value can often be obtained if the business is sold as a going concern. In order to be able to do so efficiently, secured creditors must usually be able to dispose of all these assets, including immovable property. Moreover, in such cases, States often prescribe special notice procedures for the sale and more strictly regulate the conditions under which the sale of a business as a going concern may take place.

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

67. When inventory has been effectively liquidated, the secured creditor will typically proceed to exercise another of its remedies. In such cases, most States require the secured creditor to give a further notice to the grantor and other parties with a right in the remaining assets (most often equipment, leases, licences and a remnant of inventory) that it proposes to exercise another of its remedies (e.g. acquiring the assets in satisfaction, or more commonly, selling them). Once such a notice is given, then the regular enforcement procedures applicable to that recourse will apply. Although many States now permit creditors to take over the management of a business for the purposes of gradually liquidating its inventory and equipment, the Guide does not make a formal recommendation on this point. States interested in this remedy may have to weigh the benefits against the responsibilities associated with management of a business by a secured creditor, as well as the impact of such a remedy on the rights of other creditors, secured or unsecured.

5. Effects of enforcement

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

68. In order to make the enforcement regime as expeditious as possible, States typically enact detailed rules that determine the effect of enforcement on the relationship between the grantor and the secured creditor, the rights of parties that may purchase the encumbered assets at an enforcement sale, and the rights of other secured creditors to receive the proceeds generated by the sale of the encumbered

assets. The primary object of an enforcement procedure is to generate value for the secured creditor that can be deployed to satisfy the unpaid secured obligation. In the most common situation, the secured creditor will acquire this value by selling the encumbered assets and appropriating the proceeds. Should there be a surplus, the secured creditor must return it to the grantor or to any other person entitled to it. Moreover, as just noted, should there be a deficiency, most States provide that the secured creditor retains an ordinary contractual right to sue the grantor for the deficiency as an unsecured creditor. The details of how proceeds of disposition are normally allocated in these cases have already been discussed (see paras. 57-59 above).

69. As noted, however, sometimes the secured creditor will acquire the encumbered asset in satisfaction of the secured obligation. Not all States adopt identical rules to govern the effects of this particular remedy. Usually, States provide that the creditor that acquires the asset in satisfaction may keep it, even where the value of the asset exceeds the amount of the secured obligation still owed. This means that, unlike the case of a sale, the secured creditor may keep a surplus. Concomitantly, many of these States provide that the secured creditor that acquires the asset in satisfaction of the obligation has no recourse for a deficiency against the grantor. The acquisition is deemed to be complete payment and therefore extinguishes the secured obligation. By contrast, however, other States permit creditors that have taken encumbered assets in satisfaction of the secured obligation to pursue their grantor for a deficiency. In these cases, it becomes necessary to establish the value of the assets being taken in satisfaction so that the amount of the deficiency may be calculated. Some States require the secured creditor to provide an independent accounting of the value of these assets taken, while other States merely require the secured creditor to indicate the value that it ascribes to these assets. In either case, as noted, the grantor or other creditor may require the secured creditor to sell the asset instead. For reasons already given (see para. 64 above), the Guide recommends that secured creditors may take the asset in total or partial satisfaction of the secured obligation, provided that they indicate the value they ascribe to it in the notice sent to the grantor and third parties (see recommendation 154).

(b) Other parties

70. When a secured creditor enforces its security right by means of a sale of the encumbered assets, there are different approaches to determining the effects of the sale on other parties. In some States, the sale (even when it is an extrajudicial sale) will extinguish all security rights in the encumbered assets. In such cases, even secured creditors with a priority ranking higher than that of the enforcing secured creditor will lose their security rights and will only have a claim in the proceeds with an equivalent priority ranking. Parties that purchase the assets will obtain a clear title and, it is presumed, will be willing to pay a premium to do so. In other States, the sale by a creditor (whether it is managed by a judicial officer or it is a private sale by the creditor) will only extinguish rights with a lower priority ranking than that of the enforcing secured creditor and the secured creditor with a higher priority ranking will retain its security right in the encumbered assets. Purchasers at the sale will not obtain a clear title and will, consequently, discount the amount they offer for the assets being sold. The assumption is that the highest ranking secured creditor normally will either take over the enforcement (so that all security rights will be extinguished) or that a lower ranking secured creditor will arrange to pay off

the higher ranking creditor so as to produce a clear title. While either approach usually will produce a clear title, the second approach maximizes the flexibility of the enforcing creditor and the purchaser to reach an alternative arrangement in the event that the purchaser cannot finance the entire cost of the secured asset and is willing to purchase it for a discounted price because it is subject to a higher ranking security right. To maximize flexibility and efficiency in enforcement, the Guide recommends adoption of the second approach with respect to extrajudicial dispositions (see recommendations 158-160). As to judicial dispositions, to avoid interference with general rules of civil procedure governing execution proceedings, the Guide leaves the matters to other law (see recommendation 157).

71. When a secured creditor acquires the encumbered assets in satisfaction of the secured obligation, States usually provide that the secured creditor acquires the assets as if they were transferred through an enforcement sale. While it is possible that States could provide that an acquisition in satisfaction of the secured obligation operates a purge of all rights, this would invariably lead secured creditors with a higher priority ranking than that of the enforcing secured creditor to take over the enforcement process. Therefore, most States provide that the rights of other secured creditors are determined by their priority relative to the enforcing creditor. So, for example, where a State permits a secured creditor to take an encumbered asset in satisfaction of the secured obligation, that creditor will acquire the asset subject to the rights of secured creditors with a higher priority ranking. Conversely, if there are secured creditors with even lower priority, their rights will normally be extinguished upon acquisition of the encumbered assets by a secured creditor with higher priority. For the same reasons that apply to the remedy of extrajudicial sale, the Guide recommends that the secured creditor that acquires the asset in satisfaction takes it free of lower priority security rights, but subject to the rights of secured creditors with a higher priority (see recommendation 158).

(c) Finality

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

6. Enforcement of a security right in proceeds

73. If the grantor sells the encumbered assets (in particular with the authorization of the secured creditor, in which case the security right does not continue in the encumbered assets; see recommendation 77, subparagraph (a)), the proceeds of the sale take the place of the encumbered assets (for the definition of "proceeds", see Introduction, section B. Terminology). Hence, many States provide that a security right in tangible assets will automatically pass into the proceeds of its disposition. Other States either do not so provide, or require that the security agreement expressly indicate which proceeds will be covered by the security. The Guide recommends that secured creditors have a right to claim their security in proceeds of encumbered assets and proceeds of proceeds (see recommendations 39 and 40). Moreover, unlike many States that limit the concept of proceeds to replacement assets, the Guide considers proceeds to include anything that is received on account of the encumbered asset, any fruits and revenues it generates and the natural increase of animals or plants.

74. Generally, States do not enact separate rules governing the enforcement of security rights in proceeds. This means that enforcement against proceeds will follow whatever type of process is required in order to enforce security against that type of asset (e.g. a tangible asset, a receivable, a negotiable instrument, rights to payment of funds credited to a bank account, and so on). It would create considerable confusion if secured creditors were able to enforce security rights in proceeds according to the rules governing enforcement against the initially encumbered assets when other creditors seeking to enforce security rights against those proceeds as initially encumbered assets would have to follow rules specifically applicable to that type of asset. By not recommending special enforcement rules applicable to proceeds, the Guide implicitly recommends that the general enforcement rules apply also to the enforcement of security rights in proceeds, except if the proceeds are receivables or other specific assets like those mentioned in section B of this chapter. In such cases, the asset-specific enforcement recommendations described therein would apply.

7. Intersection of movable and immovable property enforcement regimes

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

76. States have enacted many different rules to govern these various situations. A primary concern is to establish the rights of creditors that seek to enforce security rights in movable assets where movable and immovable property enforcement regimes may intersect. Most often, these enforcement regimes depend on the

characterization given to the assets. So, for example, many States permit the creation of a security right under secured transactions laws (applicable to movable assets) in movable assets that, while they are part of immovable property, are destined to become movable, but postpone effectiveness until detachment. No enforcement of the security right can take place until the asset becomes movable, and no enforcement of an encumbrance in immovable property may be taken against assets that have become movable. While the Guide makes no specific recommendation on this question, because the enforcement regime presupposes the separate existence of tangible assets as movable assets such a result implicitly follows.

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

78. The Guide follows the general pattern that many States have adopted for resolving conflicts between creditors with competing rights in attachments. Where tangible assets lose their identity through incorporation into immovable assets, any security right in the movable assets is extinguished. Where, however, the movable assets become an attachment, the security right continues, and its effectiveness against third parties is preserved automatically. The secured creditor may also ensure third-party effectiveness by registration of the security right in the immovable property registry (see recommendations 38 and 42). The enforcement rights of the secured creditor as against the attachment, and in relation to secured creditors that may have security rights in the immovable property, will then depend on the relative priority of the competing rights (see recommendations 84 and 85). If the secured creditor with rights in the attachment has priority, it may detach the assets and enforce its security right as a security right in the movable assets, subject to the right of the secured creditor or other interested party paying the value of the attachment. If, however, detachment of an attachment to immovable property (e.g. an elevator from a building) damages the immovable property (not by diminishing its value), the enforcing secured creditor has to compensate persons with rights in the immovable property. If another creditor with a security right in the immovable property has priority, the secured creditor can enforce its rights only under the regime governing security rights in immovable property, provided that it has maintained effectiveness against third parties by registering in the immovable property registry (see recommendations 161, subparagraph (a), and 162).

79. The enforcement of security rights in attachments to immovable property is further complicated where the secured creditor has taken an encumbrance in the

immovable property and a security right in the movable asset that has become an attachment to the immovable property. Most States enable the creditor in such cases to enforce the security in a variety of ways. The creditor may enforce the security right in the attachment and the encumbrance against the rest of the immovable property. Alternatively, the secured creditor may enforce the encumbrance against the entire immovable property, including the attachment. In the former case, the secured creditor would have to have priority over all rights in the immovable property (see recommendation 162). In the latter case, the rights of the creditor would be determined by the priority regime governing immovable property (see recommendation 161, subparagraph (b)).

8. Enforcement of a security right in an attachment to movable assets, a mass or a product

80. Many types of tangible asset in which a security right has been created are destined either to be attached to other tangible assets, to be manufactured into a product or to be commingled with other tangible assets into a mass. Many States deal with security rights in such cases by rules that determine whether ownership in the attachment, manufactured product or mass has passed to a third party. The Guide recommends that security rights that are effective against third parties generally should continue in assets that have become attached to other assets, in assets that are manufactured or processed into products and in assets that are commingled with other assets into a mass (see recommendations 41-44). Where States permit continued third-party effectiveness of security rights in tangible assets that are attachments, manufactured products or commingled assets, they normally also apply the general rules to enforcement against this type of asset (e.g. automobile engines, manufactured fibreglass products, commingled inventories of clothing, grain in a silo and oil in a tank). The assumption is that it would create unnecessary confusion if an enforcement regime other than that generally applicable were to be enacted.

81. With respect to the enforcement of a security right in an attachment to a movable asset, similar rules apply as in the case of security rights in attachments to immovable property. A secured creditor with a lower priority ranking than that of the enforcing secured creditor may pay off the claim of the enforcing secured creditor; a secured creditor with a higher priority ranking may take over the enforcement process; and the enforcing secured creditor is liable for any damage cause by the act of removal of the attachment. However, the difference with the treatment of a security right in an attachment to immovable property is that a secured creditor does not need to have priority as against competing rights in the movable asset to enforce its security right in the attachment (see recommendations 162 and 163).

82. In cases of products or masses, more than one secured creditor may have rights in the end product and the component assets. If the encumbered assets can be separated (as is the case with masses), the secured creditor with an enforceable security right against only a part of the assets should be able to separate the part in which it has a security right and dispose of that part following the general rules. If the encumbered assets cannot be separated (as is the case with products), the whole product may have to be sold and the rights of competing secured creditors that may have rights in other parts of the commingled assets will be determined by recommendations relating to priority (see recommendations 87-89).

B. Asset-specific remarks

1. General

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

2. Enforcement of a security right in a receivable

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

85. In chapter VIII, Rights and obligations of the parties to a security agreement, the Guide discusses the relationship between the assignor, the assignee and the debtor of the receivable. Issues discussed include, for example, the right of the assignee to inform the debtor of the receivable to make payments directly to the assignee following the assignor's default (see recommendations 111-113). The Guide also provides, in chapter IX, Rights and obligations of third-party obligors, inter alia, that the debtor of the receivable is protected against having to pay twice by the notification and payment instruction given by the assignee or the assignor (see recommendations 114-120).

86. Many States take the position that the assignee's primary enforcement right is simply to collect the receivable. Assuming that it has followed the steps required to

make its rights effective against the debtor of the receivable, the assignee will simply collect payment, applying the proceeds to reduction of the assignor's obligation. The rationale is that the rights of the assignor and third parties will be protected simply by the normal application of the money received to a reduction of the secured obligation. Consistent with the approach taken by these States, the Guide recommends that no further steps to achieve enforcement need be taken (see recommendation 165).

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

88. In some cases, the receivable itself will be secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right in movable assets of the debtor of the receivable). Many States provide for an automatic right of the assignee to enforce these other rights should the debtor of the receivable be in default to pay the receivable as it falls due. This is a normal consequence of a security right (the accessory follows the principal) and the Guide adopts a like recommendation concerning guarantees of the third-party obligor's obligation to pay (see recommendation 166). This rule applies to the right to receive the proceeds under an independent undertaking as well (see recommendations 25, subparagraph (b), 48, 104, 124 and 166).

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

89. The Guide applies to outright transfers of receivables as well as security rights in receivables (see recommendation 3). However, in an outright transfer, the assignor has generally transferred all of its rights in the receivable. Thus, the assignor has no continuing right in the receivable and no interest in the realization (usually collection) of the receivable. Accordingly, the present chapter on enforcement applies to the outright transfer of a receivable only when the assignee has some recourse to the assignor for the non-collection of the receivables. That is, it is only where the assignor may ultimately be liable to the assignee that it has an interest in the method of the collection or other disposition of the receivables (see recommendation 164).

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

91. Recourse to the assignor for non-collection as used here refers only to non-collection because of the failure of the debtor of the receivable to pay for credit reasons (e.g. its financial inability to pay). Consequently, the failure of the debtor of the receivable to pay for tangible assets or services because of their poor quality or the failure of the assignor to comply with its specifications for the assets or services would not be considered as non-collection. Where non-payment arises for credit reasons, however, the normal rules for collection of receivables and enforcement of the security would apply (see recommendations 165 and 166).

4. Enforcement of a security right in a negotiable instrument

92. In many States, it is possible to acquire a security right in a negotiable instrument (for the definition of "negotiable instrument", see Introduction, section B, Terminology), whether by taking possession or following other steps to achieve third-party effectiveness (see recommendations 32 and 37). As a general rule, even where there is a security right in the instrument, States defer to law governing negotiable instruments in determining the rights of persons obligated on the negotiable instrument and other persons claiming rights in the negotiable instrument (see recommendation 121). These rights might include, for example: (a) the right of the person obligated on the negotiable instrument to refuse to pay anyone other than a holder or other person entitled to enforce the instrument under law governing negotiable instruments; and (b) the right of the person obligated on the instrument to raise certain defences to that obligation.

93. Where security is taken in a negotiable instrument, secured creditors will normally have possession of the instrument. Upon default of the grantor, many States permit the secured creditor to collect or otherwise enforce its security right in the instrument. This would include, for example, presenting it for payment, or, if default occurs before maturity, even selling it to a third party and using the proceeds to pay the grantor's obligation. The rationale is that it would compromise the negotiability of the instrument if the secured creditor were obliged to go through the formalities required to exercise either the recourse of sale or taking the instrument in satisfaction of the secured obligation. Consistent with such practices, the Guide does not recommend that any further post-default formalities be imposed on enforcing secured creditors (see recommendation 167).

94. As with receivables, it may be that the negotiable instrument is itself secured by some other personal or property right (e.g. a personal guarantee by a third party or a security right in movable assets of the debtor of the receivable). Many States provide for an automatic right of the secured creditor to enforce these other rights should the person obligated under the negotiable instrument fail to pay upon presentment. The Guide recommends such an approach to enforcement of guarantees relating to the payment of a negotiable instrument (see recommendation 168).

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

95. Many States envision the possibility of creating a security right in a right to payment of funds credited to a bank account (for the definition of this term and other relevant terms, see Introduction, section B, Terminology). In a bank account agreement, the bank is usually considered to be the debtor of the depositor and is

obliged to pay the depositor a portion of or the whole amount on deposit when requested. As banking law is closely tied to significant commercial practices, the Guide recommends deference to banking law and also provides additional safeguards for banks whose depositors may have granted security rights in their rights to payment of funds credited to a bank account (see recommendations 32, 49, 100, 101, 122 and 123). For example, even if a depositor has concluded a security agreement with a creditor, the depositary bank has: (a) the same rights and obligations in relation to its depositor; (b) the same rights of set-off; (c) no obligation to pay any person other than the person that has control of the account; and (d) no obligation to respond to any requests for information (see recommendations 122 and 123).

96. Many States provide that, if the encumbered asset is a right to payment of funds credited to a bank account, the secured creditor may collect or otherwise enforce its right to payment of the funds after default or even before default if so agreed with the grantor. Enforcement would normally occur by the secured creditor asking the bank to transfer the funds to its own account, or otherwise to collect the sums credited to the account. The rationale for this rule is that the encumbered asset is the right to receive payment of the funds credited to the account and that it would be inefficient if the secured creditor were required to enforce by taking possession and following the steps applicable to the sale of encumbered assets or by taking them in satisfaction of the secured obligation. Consistent with the objective of enhancing flexibility and efficiency in enforcement, the Guide recommends that creditors enforcing security in a right to payment of funds credited to a bank account may do so by collecting the money in the account (see recommendation 169).

97. Sometimes, States require the secured creditor to obtain a court order prior to enforcement of a security right in a right to payment of funds credited to a bank account. Such a requirement is understandable in situations where the secured creditor may have obtained third-party effectiveness through registration in the general security rights registry. However, where the bank is aware of the security right because it has entered into a control agreement with the secured creditor, requiring a court order would be an unnecessary formality. For this reason, the Guide recommends that, where a control agreement has been entered into, it is not necessary to obtain a court order for the secured creditor to commence enforcement (see recommendation 170). Conversely, where no such agreement has been entered into, the Guide recommends that a court order be required, unless the bank specifically consents to collection by the secured creditor (see recommendation 171).

98. In many cases, the secured creditor will, in fact, be the depositary bank itself. Here, a formal enforcement process involving a specific act of collection and appropriation of the funds to repayment of the secured obligation would be superfluous. Upon default, a depositary bank acting as a secured creditor normally will deploy its right of set-off to apply the funds in the account directly to payment of the secured obligation in default. In keeping with this practice, the Guide recommends that enforcement of the depositary bank's rights of set-off not be affected by any security rights that the bank may have in the right to payment of funds in that account (see recommendations 26 and 122, subparagraph (b)).

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

99. Some States permit persons that have the right to demand payment ("to draw") under an independent undertaking to grant security in the right to receive the proceeds of that right (for the definition of this term and other relevant terms, see Introduction, section B, Terminology). The Guide recommends that security rights may be created in the right to receive such proceeds, subject to a series of rules governing the obligations between the guarantor/issuer, confirmer or nominated person and the secured creditor (see recommendations, 27, 48 and 50). As the law and commercial practices governing independent undertakings are quite specialized, the Guide recommends adoption of a number of rules meant to reflect existing law and practice (see recommendations 124-126). So, for example, where the security right is automatically created, no separate act of transfer by the grantor should be necessary for the secured creditor to enforce a security right in a right to proceeds under an independent undertaking.

100. The general practice of States is to permit a secured creditor whose security right is in the right to receive the proceeds under an independent undertaking to collect or otherwise enforce its right to payment of the proceeds after default or even before default if so agreed with the grantor. However, enforcement does not permit the secured creditor to demand payment from the guarantor/issuer, confirmer or nominated person (see recommendation 27). Rather, enforcement would normally occur when the secured creditor indicates to the guarantor/issuer, confirmer or other nominated person that it is entitled to be paid whatever proceeds are otherwise due to the grantor. The rationale for this approach is that the guarantor/issuer, confirmer or other nominated person cannot be obliged towards anyone other than the beneficiary and only the beneficiary may request payment of the independent undertaking. The Guide follows the practice relating to independent undertakings and recommends that the enforcement of the security right be limited to collecting the proceeds once they have been paid (see recommendation 172).

7. Enforcement of a security right in a negotiable document

101. Many States permit grantors to create a security right in a negotiable document (for the definition of this term and other relevant terms, see Introduction, section B, Terminology). The Guide recommends a similar practice (see recommendations 2, subparagraph (a), and 28). The negotiable document itself represents the tangible assets that are described in it and permits the holder of the document to claim those assets from the issuer of the document. Normally, secured creditors will enforce their security right by presenting the document to the issuer and claiming the assets. Special rules may, however, apply to preserve the rights of certain persons under the law governing negotiable documents and the Guide defers to that law (see recommendation 127).

102. Nonetheless, as between the grantor and the secured creditor, enforcement will occur when the secured creditor presents the document to the issuer. At this point, the secured creditor will be in possession of tangible assets and enforcement of the security right will then be subject to the normal principles recommended for the enforcement of security rights in negotiable documents or tangible assets covered by them (see recommendation 173). Depending on the agreement between the parties, either upon default or prior to default with the grantor's permission, the secured

creditor may dispose of the document. This must be done in a commercially reasonable manner and the price obtained for the sale of the document will be applied to satisfaction of the secured obligation.

C. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/637 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.*]