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Draft legislative guide on secured transactions

Note by the Secretariat*

Addendum

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XII. Conflict of laws

A. General remarks

1. Introduction

(a) Purpose of conflict-of-laws rules

1. The central purpose of the Guide is to assist States in the development of modern secured transactions laws with a view to promoting the availability of secured credit, thus promoting the growth of domestic businesses and generally increasing trade (see para. […]). In order to achieve this purpose, a secured transactions law has to facilitate credit both from domestic and foreign lenders and from other credit providers, promoting the growth of domestic businesses and generally increasing trade. Much of secured transactions law is meant to deal with grantors, secured creditors, third-party obligors and third-party creditors that are all located in the same State. It is also directed to security agreements covering encumbered assets also located in this same State, both at the time the security right is created and at all times thereafter. However, a significant part of modern commercial activity is not of this type. Increasingly, secured transactions law involves agreements between or affecting parties located in more than one State, or relating to assets that are meant for export or import, or are located in more than one State, or that are normally used in more than one State. Necessarily, therefore, to achieve comprehensiveness the Guide must address a broad range of issues that arise from various types of cross-border transaction.

2. This chapter discusses the rules for determining the law applicable to the creation, effectiveness against third parties ("third-party effectiveness"), priority as against the rights of competing claimants and enforcement of a security right (for the definitions of the terms "security right", "priority" and "competing claimant", see Introduction, section B, Terminology). These rules, generally referred to as conflict-of-laws rules, also determine the territorial scope of the substantive rules envisaged in the Guide (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Guide apply). For example, if a State has enacted the substantive law rules envisaged in the Guide relating to the priority of a security right, those rules will apply to a priority contest arising in the enacting State only to the extent that the forum[1] State's conflict-of-laws rule on priority issues points to the laws of that State. Should the forum State's conflict-of-laws rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State.

3. The conflict-of-laws rules proposed in the Guide will apply only if the forum State is a State that has enacted the rules recommended by the Guide. They cannot apply in a State that has not enacted those rules. This is so because a State cannot legislate on the conflict-of-laws rules to be applied in another State. The courts of

[1] The term "forum State" refers to the State in respect of which one has to ascertain the substantive law to apply in that State. Ascertaining the applicable law is necessary not only in a litigation context but also in every instance where there is a need to know if a transaction will provide its intended legal effects.

the other State apply their own conflict-of-laws rules in order to determine whether to apply their domestic substantive law or the substantive law of another State.

4. The conflict-of-laws rules indicate the State whose substantive law will apply to a situation by identifying the factors that connect the situation to that State. The main connecting factors recommended by the Guide are the location of the encumbered assets and the location of the grantor of the security right. Thus, in a situation where the connecting factor is the location of the assets, the law applicable will be that of the State of the location of the assets.

5. After a security right has been created and has become effective against third parties, a change might occur in one or more connecting factors. For example, if the third-party effectiveness of a security right in inventory located in State A is governed under the conflict-of-laws rules of State A by the law of the location of the inventory, the question arises as to what happens if part of the inventory is subsequently moved to State B (whose conflict-of-laws rules also provide that the law of the location of tangible assets governs the third-party effectiveness of security rights in tangible assets). One approach would be for the security right to continue to be effective in State B without the need to take any further step in State B. Another approach would be to require that a new security right be obtained under the laws of State B. Yet another approach would be for the secured creditor's pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (e.g. 30 days after the goods have been brought into State B). As this is a matter of substantive law rather than conflict of laws, the Guide addresses it in chapter V dealing with third-party effectiveness (see paras. […] and recommendation 45). This chapter deals only with the time that is relevant for the determination of whether a security right has been created, made effective against third parties and obtained priority over another right.

6. In an efficient secured transactions regime, conflict-of-laws rules applicable to secured transactions normally reflect the objectives of the secured transactions regime. This means that the law applicable to the property aspects of a security right should be easy to determine. Certainty is a key objective in the development of rules affecting secured transactions both at the substantive and the conflict-of-laws levels. Another objective is predictability. As illustrated by the example mentioned in the preceding paragraph, conflict-of-laws rules should provide an answer to the question of whether a security right acquired under the law of State A remains subject to that law or becomes subject to the law of State B if a subsequent change in the connecting factor were to point to the law of State B for a security right of the same type. A third key objective of an efficient conflict-of-laws system is that the relevant rules should reflect the reasonable expectations of interested parties (i.e. creditor, grantor, debtor and third parties). In order to achieve this result, the connecting factor that indicates the law applicable to a security right must have some real relation to the factual situation that will be governed by such law.

7. Use of the Guide (including this chapter) in developing secured transactions laws will help to reduce the risks and costs resulting from divergences among current conflict-of-laws regimes. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place (including in a jurisdiction administering insolvency proceedings with respect to the grantor and its assets). If those States have different conflict-of-laws rules for the same type of encumbered asset, the creditor will need

to comply with more than one regime in order to be fully protected (a result that is likely to affect the availability and the cost of credit). A benefit of different States having harmonized their conflict-of-laws rules is that a creditor can rely on the same conflict-of-laws rule (leading to the same results) to determine the status of its security in all those States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention and in respect of indirectly held securities by the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted by the Hague Conference on Private International Law in December 2002 (hereinafter referred to as "the Hague Securities Convention").

8. Conflict-of-laws rules would be necessary even if all States had harmonized their substantive secured transactions laws. There would remain instances where the parties would have to identify the State whose requirements will apply. For example, if the laws of all States provided that a non-possessory security right is made effective against third parties by registration of a notice in a public registry, one would still need to know in which State's registry the registration must be made.

(b) Scope of conflict-of-laws rules

9. This chapter does not define the security rights to which the conflict-of-laws rules will apply. Normally, the characterization of a right as a security right for conflict-of-laws purposes will reflect the substantive secured transactions law in a State. In principle, a court will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule. The question arises, however, as to whether the conflict-of-laws rules of a State relating to security rights should also apply to other transactions that are functionally similar to security rights, even if they are not covered by the substantive secured transactions regime of that State (e.g. retention-of-title sales, financial leases and other similar transactions). The fact that the substantive secured transactions law of a State might not apply to those other transactions should not preclude the State from applying to those transactions the conflict-of-laws rules applicable to security rights. The Guide recommends this approach to a State that would adopt the non-unitary approach to acquisition financing (see recommendation 199).

10. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation, third-party effectiveness and priority of the transfer be the same as for a security right in the same type of asset. An example is found in the United Nations Assignment Convention, which (including its conflict-of-laws rules) applies to outright transfers of receivables as well as to security rights in receivables (see article 2, subparagraph (a) of the Convention). This policy choice is motivated, notably, by the necessity of referring to one single law to determine priority between competing claimants with a right in the same receivable. The Guide adopts the same policy (see recommendation 205). Otherwise, in the event of a priority dispute between a purchaser of a receivable and a creditor with a security right in the same receivable, it would be more difficult (and sometimes impossible) to determine who is entitled to priority if the priority of the purchaser were governed by the law of State A but the priority of the secured creditor were governed by the law of State B.

11. Whatever decision a State makes with respect to the range of transactions covered by the conflict-of-laws rules, the scope of those rules on creation, third-party effectiveness and priority of a security right will be confined to the property aspects of the relevant transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the requirements to be met for a property right to be created in the encumbered assets. The rule would not apply to the personal obligations of the parties under their contract. In most States, purely contractual obligations arising from a commercial transaction are generally subject to the law chosen by the parties in their security agreement or, in the absence of such a choice, by the law governing the security agreement as determined by the conflict-of-laws rules of the relevant State (e.g. the Convention on the Law Applicable to Contractual Obligations,[2] concluded in Rome in 1980, hereinafter the "Rome Convention"). The Guide recommends the same approach for the determination of the mutual rights and obligations of the grantor and the secured creditor with respect to the security right (see recommendation 213).

12. A corollary to recognizing party autonomy with respect to the personal obligations of the parties is that the conflict-of-laws rules applicable to the property aspects of secured transactions are matters that are outside the domain of freedom of contract. For example, the grantor and the secured creditor are normally not permitted to select the law applicable to priority, since this could not only affect the rights of third parties, but could also result in a priority contest between two competing security rights being subject to two different laws leading to opposite results.

13. The conflict-of-laws rules of many States now provide that reference to the law of another State as the law governing an issue refers to the law applicable in that State other than its conflict rules. The doctrine of renvoi is excluded, for the sake of predictability and also because renvoi may lead to results that run contrary to the expectations of the parties. The Guide adopts the same approach (see recommendation 218).

(c) Outline of this chapter

14. This chapter discusses, in section A.2, the conflict-of-laws rules for the creation, third-party effectiveness and priority of a security right in general. Section A.3 reviews the law applicable to the creation, third-party effectiveness and priority of a security right in tangible assets, while section A.4 elaborates the law applicable to the creation, third-party effectiveness and priority of a security right in intangible assets and section A.5 discusses the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds. The chapter then considers, in section A.6, the law applicable to the rights and obligations of the parties to the security agreement, and in section A.7, the law applicable to the rights and obligations of third-party obligors. The law applicable to the enforcement of a security right is commented on in section A.8. The last three sections of the chapter deal with the rules and relevant time for the determination of location (section A.9), public policy and internally mandatory rules (section A.10) and special rules when the applicable law is the law of a multi-unit State (section A.11). The chapter concludes, in section B, with a series of recommendations.

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[2] United Nations, *Treaty Series*, vol. 1605, No. 28023.

2. Conflict-of-laws rules for the creation, third-party effectiveness and priority of a security right

15. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis, as follows:

(a) The first issue is whether the security has been created (for matters covered by the notion of creation, see chapter IV of the Guide);

(b) The second issue is whether the security is effective against third parties (for matters covered by the notion of third-party effectiveness, see chapter V of the Guide); and

(c) The third issue is what is the priority ranking of the right of a secured creditor as against the right of a competing claimant, such as another creditor or an administrator in the insolvency of the grantor (for matters covered by the notion of priority, see chapter VII of the Guide).

16. Indeed, a security right is of little practical value if it cannot be efficiently enforced. This question does not, however, relate to the extent of the rights that the secured creditor has in the encumbered assets, and the conflict-of-laws rules on enforcement will be discussed in another section of this chapter.

17. Not all States draw a distinction between the three issues mentioned in paragraph 15. In many States, a security right (or other property right) once created is by definition effective against all (*erga omnes*) without any further action. In those States, the same conflict rule applies to the creation of a security right and its effectiveness against third parties (and priority may be analysed also as an issue of effectiveness). However, even States that clearly distinguish among effectiveness as between the parties (creation), effectiveness against third parties and priority do not always establish a separate conflict-of-laws rule for each of those issues; thus the same conflict-of-laws rule may apply to each of the three issues resulting in the substantive law of the same State being applicable to all such issues.

18. Therefore, the key question is whether one single conflict-of-laws rule should apply to all three issues. Policy considerations, such as simplicity and certainty, favour the application of only one rule. As noted above, the distinction among these issues is not always made or understood in the same manner in all States, with the result that providing different conflict-of-laws rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding statutory security or a judgement creditor or an insolvency administrator.

19. Another important question is whether, on any given issue (i.e. creation, third-party effectiveness or priority), the relevant conflict-of-laws rule should be the same for tangible and intangible assets. A positive answer to that question would favour either a rule based on the law of the location of the grantor or a rule based on the law of the location of the encumbered assets (*lex situs* or *lex rei sitae*).

20. In the case of receivables, an approach based on the *lex situs* would be inconsistent with the United Nations Assignment Convention (article 22 of which refers to the law of the State in which the assignor, i.e. the grantor, is located). Moreover, as intangible assets are not capable of physical possession, adopting the

lex situs as the applicable conflict-of-laws rule would require the development of special rules and legal fictions for the determination of the actual location of various types of intangible asset. For this reason, the Guide does not consider the location of the asset as being the appropriate connecting factor for intangible assets and favours an approach generally based on the law of the location of the grantor (see recommendation 205).

21. In addition, consistency with the United Nations Assignment Convention would dictate defining the location of the grantor in the same way as in the Convention (see recommendation 216). Under the Convention, the grantor's location is its place of business or, if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see article 5, subparagraph (h), of the Convention). This definition was adopted by the Convention mainly because that location was considered as being the real location of the grantor and also leads to the law of the State in which the main insolvency proceedings with respect to the grantor will most likely be opened.

22. Simplicity and certainty considerations could even support the adoption of the same conflict-of-laws rule (e.g. the law of the grantor's location) not only for intangible assets but also for tangible assets, especially if the same law were to apply to the creation, third-party effectiveness and priority of a security right. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right in the same assets governed by the law of State B).

23. Not all States, however, regard the law of the location of the grantor as sufficiently connected to security rights in tangible assets, at least for "non-mobile" assets (or even in certain types of intangible asset, such as rights to payment of funds credited to a bank account or intellectual property). Moreover, in many cases, adoption of the grantor's location law would result in one law governing a secured transaction and another law governing a transfer of ownership in the same assets. To avoid this result, States would need to adopt the grantor's location law for all transfers of ownership.

24. In addition, it is almost universally accepted that a possessory security right should be governed by the law of the place where the assets are held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor's location were to be the general rule, an exception would need to be made for possessory security rights.

25. For all these reasons, the Guide recommends two general conflict-of-laws rules on the law applicable to the creation, third-party effectiveness and priority of a security right, as follows:

(a) With respect to tangible assets, the applicable law should be the law of the location of the assets (see recommendation 200);

(b) With respect to intangible assets, the applicable law should be the law of the location of the grantor (see recommendation 205).

26. As the conflict-of-laws rules generally will be different depending on the tangible or intangible character of the assets, the question arises as to which conflict rule is appropriate where intangible assets are capable of being the subject of a possessory security right. In this regard, most States assimilate certain categories of rights embodied in a document (such as a negotiable instrument) to tangible assets, thereby recognizing that a possessory security right may be created in such assets through the delivery of the document to the creditor. The Guide treats these types of intangible assets as tangible assets (for the definition of "tangible assets", see Introduction, section B, Terminology) and, accordingly, the conflict-of-laws rule for tangible assets generally applies to such intangible assets. Accordingly, the law of the State where the instrument is held will govern the creation, third-party effectiveness and priority of a security right in a negotiable instrument (see recommendation 200).

27. A related issue arises where tangible assets are represented by a negotiable document of title (such as a bill of lading). It is generally accepted that a negotiable document of title is also assimilated to a tangible asset and may be the subject of a possessory security right. The law of the location of the document (and not of the actual tangible assets covered thereby) would then govern the security right. The question arises, however, as to what law would apply to resolve a priority contest between a creditor with a security right in a document of title and another creditor to whom the debtor might have granted a non-possessory security right in the tangible assets themselves, if the document and the tangible assets are not held in the same State. In such a case, the conflict-of-laws rules should accord precedence to the law governing the security right in the document, on the basis that this solution would better reflect the legitimate expectations of interested parties (see recommendation 203). This result would also be consistent with the substantive law rules proposed by the Guide on creation, third-party effectiveness and priority (see recommendations 28, 52 and 105).

3. Law applicable to the creation, third-party effectiveness and priority of a security right in tangible assets

28. The policy considerations favouring the general conflict-of-laws rules set out above do not necessarily apply in all circumstances and other rules apply with respect to certain specified types of asset for which the location of the asset or of the grantor is not the most appropriate connecting factor. In addition, for efficiency purposes, alternative rules apply with respect to assets in transit and assets intended for export. Such assets are not intended to remain in their initial location and may cross the borders of several States before reaching their ultimate destination. The following paragraphs explain the two general conflict-of-laws rules outlined above and their exceptions.

(a) General rule: law of the location of the encumbered asset (*lex situs* or *lex rei sitae*)

29. As mentioned above, the creation, the effectiveness against third parties and the priority of a security right in tangible assets are generally governed by the law of the State in which the encumbered asset is located (see recommendation 200). A frequent example of the application of this rule relates to security rights in inventory.

If a grantor owns inventory located in a State that has this rule (State A), the law of that State will govern those issues. The rule also means that, if the grantor also owns other inventory in another State (State B), the relevant requirements of State B will have to be fulfilled in order for the courts of State A to recognize that the inventory located in State B is subject to the secured creditor's rights.

30. The general conflict-of-laws rule for tangible assets does not distinguish between possessory security rights and non-possessory security rights. Accordingly, the law of the location of the asset will generally apply, whether or not the secured creditor has possession of the asset. This is particularly relevant for intangible assets assimilated to tangible assets, such as negotiable instruments and negotiable documents. For example, the law of the location of the instrument or document will govern priority matters even if the security right is made effective against third parties otherwise than by possession.

(b) Additional rule for the creation and third-party effectiveness of a security right in goods in transit and export goods

31. With respect to assets in transit or assets intended for export, application of the law of the location of the goods results in the application of the law of the State in which the assets are located at the time an issue arises. A consequence of the rule is that secured creditors need to monitor the assets and follow the requirements of various States to ensure that they have at all times an effective security right. To avoid that burden, one approach would be for the State of the ultimate (or intermediate) destination to recognize as effective a security right created and made effective against third parties under the law of the initial location. Such an approach would reflect the expectations of parties in the initial location of the assets, but would be contrary to the expectations of parties that provided credit to the grantor following the requirements of the law of the ultimate destination of the assets.

32. Another approach would be for the State of the ultimate destination to recognize for a limited period of time a security right created and made effective against third parties under the law of the initial location of the assets. Parties in the initial location could then have a period of time to follow the third-party effectiveness requirements of the law of the State of the ultimate destination to preserve the effectiveness originally acquired in the initial location. Such an approach would balance the interests of parties in the various jurisdictions (and is in fact supported by the Guide for most types of tangible asset; see recommendations 45 and 200).

33. A further approach would be to offer to the secured creditor the option of creating and making its security right effective against third parties under the law of the State of the initial location of the assets or under the law of the State of the ultimate location of the assets provided in the latter case that the assets reach such location within a specified period of time (see recommendation 204). This approach would allow a secured creditor that is confident that the assets will reach the place of their intended destination to rely on the law of that place to create and make its security right effective against third parties. A rule providing for that option is particularly useful when the assets are likely to quickly transit through other States and arrive at their final destination within a short period of time after shipment. Otherwise, in the case of a security right created while the assets are at their initial location, for the security right to be continuously effective against third parties, the

secured creditor would have to fulfil the third-party effectiveness requirements of the place of the initial location, of each State where the assets could be in transit and of the place of ultimate destination. In any case, priority would always be subject to the law of the location of the assets at the time a priority dispute arises.

(c) Special rule for the creation, third-party effectiveness and priority of a security right in a negotiable instrument

34. As mentioned above, it is generally accepted that the law of the State in which a negotiable instrument is located (*lex situs*) should govern the creation, third-party effectiveness and priority of a security right in the instrument (see recommendation 200). However, in some States, the third-party effectiveness of a security right in negotiable instruments may also be achieved by registration in the place in which the grantor is located. In such a case, it is logical to rely on the law of the State of the grantor's location to determine whether third-party effectiveness has been achieved by registration (see recommendation 208). It is worth noting that this option is confined to third-party effectiveness. The law of the actual location of the instrument will always govern the priority of a security right in the instrument.

(d) Exceptions for certain types of asset

35. The general conflict-of-laws rule for security rights in tangible assets is normally subject to certain exceptions where the location of the assets would not be an efficient connecting factor (e.g. assets ordinarily used in several States) or would not correspond to the reasonable expectations of the parties (e.g. assets the ownership of which must be recorded in special registries).

(i) Mobile assets

36. Mobile assets are assets that in the normal course of business cross the borders of States (e.g. aircraft, ships or, in some cases, machinery or motor vehicles). For example, a grantor operating a construction business in several States may have to create security rights in machinery periodically moved from one State to another for the purposes of that business; or a grantor operating a transportation business may need to create security rights in the vehicles used in the transportation business (although motor vehicles may not normally cross national borders in island States). The application to mobile assets of the general conflict-of-laws rule for tangible assets would require the secured creditor to ascertain the exact location of each piece of machinery or each vehicle at the time of the creation of the security right. To ensure continued third-party effectiveness of its security right, the secured creditor would also need to enquire as to all States in which each of these assets might be potentially located at any given time and meet the relevant requirements of all such States. Moreover, it would not be possible to identify the State in which the relevant asset would be located at the time of a priority contest occurring in the future and therefore to determine the priority regime to be applied to resolve the dispute. To avoid these problems and resulting costs and uncertainties, in some States, the creation, third-party effectiveness and priority of a security right in tangible assets of a type ordinarily used in more than one State may be governed by the law of the State in which the grantor is located (except if ownership of assets of that type is subject to registration in a special registry which also allows for the

registration of security rights; see para. 37 below). The Guide follows this approach (see recommendation 201).

(ii) Tangible assets subject to specialized registration or notation on a title certificate

37. The ownership of certain categories of tangible assets is sometimes recorded in specialized registries or evidenced by a title certificate. This is generally the case for aircraft and ships and, in some States, for motor vehicles. To the extent that the relevant registry or notation system also permits the registration or notation of security rights, reference can be made to the law of the State under the authority of which the relevant registry is maintained, or the title certificate is issued, to determine the law governing the creation, third-party effectiveness and priority of a security right in an asset that is subject to registration in such a specialized registry or notation on a title certificate. Thus, a search in the registry, or an examination of the title certificate, would disclose both ownership and security rights in respect of such assets. Such a rule may be based on national law (see recommendation 202) or international conventions, which take precedence (e.g. the Convention on International Interests in Mobile Equipment and the relevant protocols thereto).

4. Law applicable to the creation, third-party effectiveness and priority of a security right in intangible assets

(a) General rule: law of the location of the grantor

38. In some States, the creation, third-party effectiveness and priority of a security right in intangible assets is governed by the law of the States in which the grantor is located. For example, if an exporter located in State A creates a security right in receivables owed by customers located in States B and C, the law of State A will govern the property right aspects of the security right. This rule is consistent with the approach followed in the United Nations Assignment Convention with respect to the law applicable to the assignment of receivables (see articles 22 and 30).

39. In other States, the law of the location of the asset (*lex situs*) still governs the creation, third-party effectiveness and priority of a security right in intangible assets. In those States, it is necessary to establish the location of an intangible asset (e.g. for a receivable, the location of the debtor of the receivable).

40. The law of the grantor's location has several advantages over the *lex situs*, especially where the encumbered intangible assets consist of receivables. One single law applies even if the assignment relates to many receivables owed by different debtors. In addition, the law of the grantor's location may be ascertained easily at the time the assignment is made, even if the assignment relates to future receivables or to receivables assigned in bulk. Moreover, the law of the grantor's location (place of central administration in the case of a grantor having places of business in more than one State) is the law of the State in which the main insolvency proceedings with respect to the grantor are likely to be administered.

41. It is also the case that, while the law of the location of the encumbered asset (*lex situs*) works well in most instances for tangible assets, great difficulties arise in applying the *lex situs* to intangible assets, both at conceptual and practical levels. From a conceptual standpoint, there is no consensus and no clear answer as to the *situs* of a receivable. One view is that it is the place where payment must be made. Another view is that the *situs* of a receivable is the legal domicile or place of

business or principal residence of the debtor of the receivable. A further view is that a receivable should be deemed to be located in the State whose law governs the contractual relationship between the original creditor (that is, the grantor) and the debtor of the receivable. Any of the foregoing alternatives would impose upon a prospective assignee the burden of having to make a detailed factual and legal investigation. Moreover, in many instances, it might prove impossible for the assignee to determine with certainty the exact location of a receivable since the criteria for determining that location may depend on business practices or the will of the parties to the contract under which the receivable arises. Thus, using the *lex situs* as the law applicable to security rights involving receivables would not provide certainty and predictability, which are key objectives for a sound conflict-of-laws regime in the area of secured transactions.

42. Furthermore, even if a State had detailed provisions allowing a prospective or existing secured creditor to ascertain easily and objectively the law of the location of a receivable, practical difficulties would still ensue in many commercial transactions. This would be so because a security right may relate not only to an existing and specifically identified receivable, but also to many other receivables. Thus, a security right may cover a pool of present and future receivables. In such a case, selecting the *lex situs* as the law governing priority would not be an efficient policy decision, as different priority rules might apply with respect to the various assigned receivables. Moreover, where future receivables are subject to a security right, it would not be possible for the secured creditor to ascertain the extent of its priority rights at the time of the transaction, since the *situs* of those future receivables is unknown at that time.

43. In view of the above, the Guide recommends that the creation, third-party effectiveness and priority of a security right in an intangible asset be governed in general by the law of the State in which the grantor is located (see recommendation 205). The criteria defining the grantor's location are consistent with those found in the United Nations Assignment Convention (see paragraphs 21 and 70; see also recommendation 216).

(b) Exceptions for certain types of asset

44. There are three categories of intangible asset in respect of which different considerations apply and the location of the grantor is not the most (or the only) appropriate connecting factor for the selection of the applicable law: rights to payment of funds credited to a bank account; rights to receive the proceeds under an independent undertaking; and receivables arising from a transaction relating to immovable property.

(i) Rights to payment of funds credited to a bank account

45. With respect to the creation, third-party effectiveness, priority and enforcement of a security right in rights to payment of funds credited to a bank account, different approaches are followed in various States (for the definition of "bank account", see Introduction, section B, Terminology). For sake of simplicity and because a bank deposit is a receivable, some States consider that the governing law for receivables in general should also apply to a bank account. A different approach is to refer to the law of the State in which the branch maintaining the account is located (see recommendation 207, alternative A). Under this approach,

certainty and transparency with regard to the applicable law would be enhanced, as the location of the relevant branch could be easily determined in a bilateral bank-client relationship. In addition, such an approach would reflect the normal expectations of parties to current banking transactions. Moreover, this approach would result in the law governing a security right in a right to payment of funds credited to a bank account being the same as that applicable to regulatory matters. The location of the branch is often viewed as the *situs* of a bank account for regulatory or other matters in respect of which the *situs* of the account must be ascertained.

46. Another approach is to refer to the law specified in the account agreement as the law governing the account agreement, or to any other law explicitly specified in the account agreement, provided that the depositary bank has a branch in the State whose law is so specified. If the account agreement does not specify any law, the applicable law could be determined using the same default criteria as those found in article 5 of the Hague Securities Convention (see recommendation 207, alternative B). Under this approach, the applicable law would meet the expectations of the parties to the account agreement. Third parties would be able to ascertain the law provided in the account agreement, as the grantor-account holder would normally supply information on the account agreement to obtain credit from a lender relying on the funds credited to the account.

47. As is the case with negotiable instruments and for the same reasons, the law of the State of the grantor's location could apply to the third-party effectiveness of a security right in a right to payment of funds credited to a bank account where third-party effectiveness may be achieved by registration in the place where the grantor has its location (see para. 34 above and recommendation 208).

(ii) Rights to receive the proceeds under an independent undertaking

48. In many States, the third-party effectiveness and priority of a security right in the right to receive the proceeds under an independent undertaking are referred to the law specified in the independent undertaking (for the definition of "right to receive the proceeds under an independent undertaking", see Introduction, section B, Terminology; for this approach, see recommendation 209). If the governing law is not specified in the independent undertaking, those matters are referred to the law of the State of the location of the relevant office of the person that has provided (or has agreed to perform, as the case may be) the undertaking (see recommendation 210). This approach is viewed as being the most closely connected to the undertaking with respect to the law applicable to those matters. It is also consistent with the normal expectations of parties to such transactions. As to the creation of a security right in such an asset, the general conflict-of-laws rule for intangible assets continues to apply in view of the fact that creation only involves the effectiveness of the security right as between the parties to the security agreement and does not affect the rights of other parties.

49. However, if an independent undertaking is issued to ensure the performance of an obligation under a receivable or negotiable instrument, the law governing the creation and third-party effectiveness of a security right in the receivable or negotiable instrument will determine whether the security right extends automatically to the independent undertaking (see recommendation 211). This approach is justified by the need to apply, for consistency reasons, the same law to

the creation and third-party effectiveness of the security right in the receivable or negotiable instrument and in the right to receive the proceeds under a related independent undertaking.

(iii) Receivables related to immovable property

50. Where a receivable arises from the sale or lease of immovable property or is secured by immovable property, as for any other receivable, the law of the State of the location of the grantor should normally govern the property aspects of a security right in the receivable. However, in the event of a priority contest where at least one of the competing claimants has registered its right in the immovable property registry of the State in which the immovable property is located, the Guide recommends that the priority contest be resolved in accordance with the law the State under whose authority the registry is maintained (see recommendation 206). The purpose of the latter rule is to ensure that the law of the State maintaining the registry actually applies to parties that are entitled by that law to rely on the registry. For the same reason, this rule is confined to a situation where, under the law of the State of the registry, registration in the registry is relevant for priority issues.

5. Law applicable to the creation, third-party effectiveness and priority of a security right in proceeds

51. There are generally three approaches to the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds (for the definition of "proceeds", see Introduction, section B, Terminology).

52. One approach is to refer, for the law applicable to a security right in proceeds, to the law applicable to the security right in the original encumbered assets. For example, if the original encumbered assets are in the form of inventory located in State A and the proceeds take the form of receivables and the grantor is located in State B, the law of State A would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Hence, a priority conflict between a security right in receivables as proceeds of inventory and a security right in receivables as original encumbered assets would be governed by the law of State A (the law of the location of the inventory). As a result, certainty as to the applicable law would be enhanced for the benefit of the inventory financiers relying on the receivables as proceeds.

53. However, this approach has significant disadvantages for the receivables financier. For example, it would result in the application of a law other than the law receivables financiers would expect to apply to their rights in the receivables as original encumbered assets. Another disadvantage is that the receivables financier would be unable to predict what the applicable law would be because the governing law would depend on whether the dispute arises with an inventory financier (in which case the law of the location of the inventory would govern) or with another competing claimant (in which case the law of the location of the grantor would govern). This approach also provides no solution in a tripartite dispute among the receivables financier, the inventory financier and another competing claimant. This approach would also undermine the choice of the law of the grantor's location as the law applicable to a security right in receivables because receivables often result from the sale of tangible assets. The receivables financier in many instances then would be unable to rely on the law of grantor's location.

54. A second approach is to refer to the law applicable to security rights in assets of the same type as the proceeds. In the example given above, the law of State B (the law of the grantor's location) would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Simplicity and certainty considerations would support such an approach: it would always be possible to determine the applicable law irrespective of the parties to the dispute.

55. Yet a third approach is to combine the two approaches mentioned above and retain the second approach as the rule for third-party effectiveness and priority of a security right in proceeds, while the first approach would apply to the creation of that right. Under this third approach, the question of whether a security right extends to proceeds would be governed by the law applicable to the creation of a right in the original encumbered assets from which the proceeds arose, while the third-party effectiveness and priority of a security right to proceeds would be subject to the law that would have been applicable to such issues if the proceeds had been original encumbered assets.

56. This approach would meet the expectations of a creditor obtaining a security right in inventory under a domestic law providing that such security right automatically extends to proceeds. It would also meet the expectations of receivables financiers as to the law that would apply to the creation, third-party effectiveness and priority of a security right in receivables as original encumbered assets. Finally, such an approach would ensure that the inventory financier could rely on the law governing its security right as to whether the right extends to proceeds and would allow all competing claimants to identify with certainty the law that will govern a potential priority contest. For all these reasons, this is the approach recommended in the Guide (see recommendation 212).

6. Law applicable to the rights and obligations of the parties to the security agreement

57. As mentioned above (see para. 11), the scope of the rules on the creation, third-party effectiveness and priority of a security right is confined to the property (in rem) aspects of the right. These rules do not apply to the mutual rights and obligations of the parties to the security agreement. Such rights and obligations are rather governed by the law chosen by them or, in the absence of a choice of law, by the law governing the agreement as determined by the conflict-of-laws rules generally applicable to contractual obligations (see recommendation 213). For example, in a State in which the Rome Convention is in effect, in the absence of a choice of law by the parties, the mutual rights and obligations of the parties to the security agreement will be subject to the law most closely connected to the security agreement (see article 4, paragraph 1, of the Rome Convention). A loan agreement whereby a security right is also granted may be presumed to be most closely connected with the State in which the party that performs the obligation that is characteristic of the agreement has its central administration or habitual residence (see article 4, paragraph 2, of the Rome Convention). In such a loan agreement, this party may be the lender. In a retention-of-title sale, it may be the seller.

7. Law applicable to the rights and obligations of third-party obligors

58. Security rights in intangible assets generally involve third parties such as, for example, the debtor of a receivable, an obligor under a negotiable instrument, the

depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document. The conflict-of-laws rules governing the property aspects or the enforcement of a security right are not necessarily appropriate for the determination of the law applicable to the obligations of third parties against whom the secured creditor may want to exercise the recourses arising from its security right. Applying these rules would frustrate the expectations of parties that have payment or other obligations arising in connection with the encumbered asset but do not take part in the transaction to which the security agreement relates.

59. In particular, the fact that a receivable has been encumbered by a security right should not result in the obligations of the debtor of the receivable becoming subject to a law different from the law governing the receivable. Similar considerations apply to the obligations of the obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document where a security right has been granted in a negotiable instrument, right to payment of funds credited to bank accounts or proceeds under an independent undertaking, or a negotiable document. It is generally accepted that the existence of the security right should not displace the law applicable to the relationship of all such parties with the grantor and that such law should also govern their relationship with the secured creditor. The conflict-of-laws rules proposed by the Guide follow this approach (see recommendation 214).

8. Law applicable to the enforcement of a security right

60. In most States, procedural matters are governed by the law of the State where the relevant procedural step is taken. However, enforcement may relate to substantive or procedural matters. Although the forum State will use its own law to determine what is substantive and what is procedural, the following are examples of issues generally considered to be substantive: the nature and extent of the remedies available to the creditor to realize the encumbered assets; whether such remedies (or some of them) may be exercised without judicial process; the conditions to be met for the secured creditor to be entitled to obtain possession and dispose of the assets (or to cause the assets to be judicially realized); the power of the secured creditor to collect receivables that are encumbered assets; and the obligations of the secured creditor to the other creditors of the grantor.

61. With respect to substantive enforcement matters, where a security right is created and made effective against third parties under the law of one State, but is sought to be enforced in another State, the question arises as to the law applicable and thus the remedies available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security right could allow enforcement by the secured creditor without prior recourse to the judicial system, while the law of the place of enforcement might require advance judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

62. One approach would be to refer enforcement remedies to the law of the place of enforcement, i.e. the law of the forum State (lex fori). The place of enforcement of security rights in tangible assets in most instances would be the place of the

location of the asset, while enforcement of a security right in intangible assets such as a receivable might take place in the location of the debtor of the receivable. The policy reasons in favour of this approach are, among others, that:

(a) The law of remedies would coincide with the law generally applicable to procedural issues;

(b) The law of remedies would, in many instances, coincide with the law of the State in which the assets being the object of the enforcement are located (and could also coincide with the law governing priority if the conflict-of-laws rules of the relevant State point to such location for priority issues);

(c) The requirements would be the same for all creditors intending to exercise rights in the place of enforcement against the assets of a grantor, irrespective of whether such rights are domestic or foreign in origin.

63. On the other hand, selecting the lex fori may result in uncertainty if the encumbered asset is an intangible asset. For example, it is not clear where enforcement is to take place if the encumbered assets are in the form of receivables. The answer to this question could be very problematic as it would require the criteria for determining the location of the receivables to be set out (see para. 41 above). In addition, the secured creditor might be located in a different State at the time the initial enforcement steps are taken. In the case of a bulk assignment involving receivables owing by debtors located in several States, multiple laws may apply to enforcement. The difficulty would be the same if one enforcement act would have to be performed in one State (e.g. notification of the debtor of the receivable) and another act in another State (e.g. collection or sale of the receivable). If future receivables are involved, the secured creditor may not know at the time of the assignment which law would govern its enforcement remedies. All this uncertainty as to the applicable law may have a negative impact on the availability and the cost of credit.

64. Another concern is that the lex fori might not give effect to the intention of the parties. The parties' expectations may be that their respective rights and obligations in an enforcement situation will be those provided by the law under which the priority of the security right will be determined. For example, if extrajudicial enforcement is permitted under the law governing the priority of the security right, this remedy should also be available to the secured creditor in the State where it has to enforce its security right, even if it is not generally allowed under the domestic law of that State.

65. So, another approach would be to refer substantive enforcement matters to the law governing the priority of a security right. The advantage of this approach would be that enforcement matters are closely connected with priority issues (e.g. the manner in which a secured creditor will enforce its security right may have an impact on the rights of competing claimants). Such an approach may have another benefit. As the law governing priority is often the same law as the law governing the creation and third-party effectiveness of the security right, the final result would be that creation, third-party effectiveness, priority and enforcement issues would often be governed by the same law.

66. A third possible approach would be a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This

approach would result in an applicable law that would often correspond to the parties' expectations. In addition, in many instances, under such an approach, the applicable law would coincide with the law applicable to the creation of the security right, since that law is frequently selected as also being the law of their contractual obligations. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum State or the law governing priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the assets of their common debtor. Therefore, referring enforcement issues to the law governing the contractual relationship of the parties would necessitate exceptions designed to take into account the interests of third parties, as well as the mandatory rules of the forum State, or of the law governing creation, third-party effectiveness and priority.

67. A fourth approach would be to attempt to reconcile the benefits of the approaches based on the law of the place of enforcement (lex fori) and the law governing priority. Under this approach, the enforcement of a security right in tangible assets may be governed by the lex fori, while the enforcement of a security right in intangible assets would be governed by the same law as the law that applies to priority. The Guide recommends this solution as it preserves the benefits of using the lex fori for tangible assets, while avoiding the difficulties that would arise if such law were to apply to intangible assets (see recommendation 215).

68. It must be noted that the above conflict-of-laws rules on enforcement do not govern the relationship between a secured creditor and third-party obligors. As mentioned above (see paragraph 59), the obligations of such persons to the secured creditor are generally governed by the same law that was applicable to their relationship to the grantor.

9. Rules and relevant time for the determination of location

69. As the general conflict-of-laws rules for security rights in tangible and intangible assets point to the location of the encumbered assets and the location of the grantor, respectively, it is essential that the appropriate location be easily identified. Tangible assets are commonly viewed as being located at the place where they are physically located and there is no need to provide a specific rule to that effect. There is such a need, however, for the determination of the location of the grantor. The legal domicile and the residence of a natural person might be in different States. Likewise, a legal person may have its statutory head office in a State other than the State in which its principal place of business or decision centre is located.

70. As mentioned above, the United Nations Assignment Convention defines the location of the grantor as follows: the grantor's location is its place of business or if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see article 5, subparagraph (h)). The Guide defines the location of the grantor in the same manner (see recommendation 216).

71. Whatever connecting factor is retained for determining the most appropriate conflict-of-laws rule for any given issue, there may be a change in the relevant

factor after a security right has been created. For example, where the applicable law is that of the State where the grantor has its head office, the grantor might later relocate its head office to another State. Similarly, where the applicable law is the law of the State where the encumbered assets are located, the assets may be moved to another State. So, it is also necessary to determine the time that is relevant for the determination of location.

72. If this issue is not dealt with specifically, the general conflict-of-laws rules on creation, third-party effectiveness and priority of a security right might be construed to mean that, in the event of a change in the relevant connecting factor, the original governing law continues to apply to creation issues (because they arose before the change, while the subsequent governing law would apply to events occurring thereafter that raise third-party effectiveness or priority issues). For example, in a situation where the law applicable to the third-party effectiveness of a security right is that of the grantor's location, the effectiveness of the right against the insolvency administrator of the grantor would be determined using the law of the State of the new location of the grantor at the time of commencement of the insolvency proceedings.

73. Silence of the law on these matters might, however, give rise to other interpretations. For example, one interpretation might be that the subsequent governing law also governs creation as between the parties in the event of a priority dispute occurring after the change (on the basis that third parties dealing with the grantor are entitled to determine the applicable law for all issues relying on the actual connecting factor being the connecting factor in effect at the time of their dealings).

74. Thus, providing guidance on these issues is necessary to allow interested parties to determine with certainty whether a change in the connecting factor would result in the application of a law other than the law initially expected by the parties to apply if the State of the new location of the assets or the grantor has a different conflict-of-laws rule. Therefore, the Guide proposes to make explicit the interpretation referred to in paragraph 73: for the purpose of determining the law applicable to creation, the relevant location should normally be the location of the encumbered asset or the grantor at the time of putative (purported or asserted) creation; for the purpose of determining the law applicable to third-party effectiveness and priority, the relevant location should be the location at the time the issue arises. However, in a dispute involving only competing claimants whose rights became effective against third parties before a change in location of the asset or the grantor, third-party effectiveness and priority issues should be governed by the law of the initial location (see recommendation 217).

10. Public policy and internationally mandatory rules

75. According to the conflict-of-laws rules of many States, the forum State may refuse the application of the law determined under its conflict-of-laws rules only if the effect of its application would be manifestly contrary to the public policy of the forum State or to provisions of the law of the forum State that are mandatory even in international situations. This rule is intended to preserve fundamental principles of justice of the forum State. For example, if, under the law of the forum State, a security right cannot be created in retirement benefits and this is a matter of public policy in the forum State, the forum State may refuse to apply a provision of the

applicable law that would recognize the creation of such a right. However, these principles should not permit the forum State to apply its own third-party effectiveness and priority rules in the place of those of the applicable law (see recommendation 219). The forum State has to apply other provisions of the applicable law to determine third-party effectiveness and priority. This approach is justified by the need to achieve certainty with respect to the law applicable to third-party effectiveness and priority. The same approach is followed in articles 23, paragraph 2, 30, paragraph 2, and 31 of the United Nations Assignment Convention. It is also followed in article 11, paragraph 3, of the Hague Securities Convention.

11. Impact of commencement of insolvency proceedings on the law applicable to security rights

76. Determining the law applicable to the creation, third-party effectiveness and priority of a security right and the post-default rights of a secured creditor may raise additional issues when insolvency proceedings are commenced in one State and some of the debtor's assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor's business. In either instance, however, most States provide that general conflict-of-laws rules applying outside of insolvency proceedings would govern these matters, subject to the limitations discussed below. This result is consistent with recommendation 30 of the *UNCITRAL Insolvency Guide*, which provides that the State in which insolvency proceedings are commenced (i.e. the forum State) should apply its conflict-of-laws rules to determine which State's law governs such questions as the validity and effectiveness of rights and claims (including security rights) existing at the time of the commencement of insolvency proceedings (see also recommendation 220 of this Guide).

77. Once, under the non-insolvency law applicable outside of insolvency proceedings by virtue of the conflict-of-laws rules of the forum State, the validity and effectiveness of a security right are determined, a second issue arises concerning the effect of commencement of insolvency proceedings on the priority of security rights. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced (*lex fori concursus*) governs the commencement, conduct, including the ranking of claims, administration and conclusion of the proceedings (the "insolvency effects") (see recommendation 31 of the *UNCITRAL Insolvency Guide*). This may have the effect of changing the relative priority that a security right would have under secured transactions law, and establish categories of claims that would receive distributions ahead of a security right in insolvency proceedings. In addition, irrespective of priority issues a security right might be subject to the avoidance provisions of the insolvency law (see recommendation 88 of the *UNCITRAL Insolvency Guide*).

78. While the insolvency effects of insolvency proceedings on security rights typically are governed by the *lex fori concursus*, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable property is located (*lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The *UNCITRAL Insolvency Guide* addresses these exceptions in more detail (see part two, chapter I, paras. 85-91), but does not recommend the adoption of a *lex rei sitae* rule for

insolvency effects as applied to attachments to immovable property or even to movable property in general. Instead, it generally recommends that any exceptions to the applicability of the *lex fori concursus* for insolvency effects should be limited in number and clearly set forth in the insolvency law (see *UNCITRAL Insolvency Guide*, recommendation 34 and part two, chapter I, para. 88).

12. Special recommendations when the applicable law is the law of a multi-unit State

79. The term "State" in the Guide refers to a sovereign State or country. The question arises, however, as to what law applies if, on a given issue, the conflict-of-laws rule refers to a State that comprises more than one territorial unit, with each unit having its own system of law in relation to the issue. This could be the case in federal States in which the secured transactions law generally falls under the legislative authority of their territorial units. For the conflict-of-laws rules to work where the applicable law is the law of such a State (even if the forum State is not a multi-unit State), it is necessary to determine the territorial unit whose law will apply.

80. Normally, references to the law of such a State are to the law in effect in the relevant territorial unit, as determined on the basis of the applicable connecting factor (such as the location of the asset or the location of the grantor). For instance, if the applicable law is the law of a multi-unit State with three territorial units (A, B and C), a reference to the law of the location of the grantor as the law applicable to a security right in receivables means a reference to the law of unit A if the place of central administration of the grantor is in unit A (see recommendation 221).

81. To preserve the consistency of the internal conflict-of-laws rules of a multi-unit State, the Guide adopts an approach followed by many international conventions and recommends that such rules continue to apply, but only internally (see recommendation 222). Using the example given in the preceding paragraph, if a grantor is located in unit A of a multi-unit State, the law of unit B would apply where the internal conflict rules of unit A would point to the law of unit B as the applicable law. This could be the case if the conflict rules of unit A contemplate (as in the Guide) that the law of the grantor's location governs the third-party effectiveness and priority of a security right in receivables but defines location differently. If the location of the grantor as defined in the Guide (that is, the place of central administration) is in unit A but the law of unit A defines the grantor's location as meaning the location of its statutory head office and such office of the grantor is in unit B, then the third-party effectiveness and priority of the security right in the receivables will be governed by the law of unit B. This appears to be a deviation from the general rule on the exclusion of renvoi (see recommendation 218). However, this "deviation" is limited to internal renvoi, which does not affect certainty as to the applicable law. In the above example, there would be no reference to a law other than that of unit A should the statutory head office of the grantor be located in a State other than the State of which unit A forms part.

82. These rules on multi-unit States are relevant only to issues that, in such a State, are governed by the laws of its territorial units. So, for example, these rules would have no impact in a federal State whose constitution provides that secured transaction matters are governed by federal laws.

83. Recommendations 223 and 224 apply only if a State adopts alternative B of recommendation 207.

B. 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.*]