



General Assembly

Distr.: Limited
11 February 2004*

Original: English

**United Nations Commission
on International Trade Law**
Working Group VI (Security Interests)
Fifth session
New York, 22-26 March 2004

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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* This document is submitted four weeks later than the required ten weeks prior to the start of the meeting because of the need to complete consultations and to finalize consequent amendments.



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Draft legislative guide on secured transactions

[Prefatory remarks to be prepared at a later stage]

I. Introduction**A. Purpose**

1. The purpose of this Guide is to assist States in the development of modern secured transactions laws with a view to promoting the availability of low-cost secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.
2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses, and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making low-cost consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see UNCITRAL Legislative Guide on Insolvency Law).
3. The Guide seeks to rise above differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable and limited costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.
4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.
5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by the assets of a debtor gives creditors access to the assets as another source of payment in the event of non-payment by the debtor. As the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls.
6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured

credit. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. On the other hand, in States that do not have efficient and effective laws, where creditors perceive the legal risks associated with credit transactions to be high, the cost of credit increases as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime, or of an insolvency law regime under which security rights are recognized, has resulted in the virtual elimination of credit for small- and medium-size commercial enterprises, as well as for consumers.

7. Creating a legal regime that promotes secured credit not only aids in the cultivation and growth of individual businesses, but also can have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves a valuable economic benefit.

8. To best promote the availability of low-cost secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their property to the maximum extent possible to obtain credit. In this regard, the Guide adopts two of the most essential concepts of successful secured transactions laws, the concepts of priority and publicity. The concept of priority, which allows the ranking of creditors with a security right in the same assets, makes it possible for a business to utilize the value of its assets to the maximum extent possible by granting security rights having a different priority status in the same assets to more than one creditor. The concept of publicity in the form of a system allowing the registration of a notice concerning a secured transaction is designed to promote legal certainty with regard to the relative priority status of creditors and thus to reduce the costs associated with secured transactions.

B. Scope

9. The Guide deals with consensual security rights. However, it contains references to non-consensual rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.9/Add.3, paras. 44-53). The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of asset are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, with the exception of assets specifically excluded.

10. Examples of excluded assets are ships, aircraft, real property and other assets that are subject to special registration systems. In addition, the Guide does not cover security rights in securities as original encumbered assets because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. These issues are dealt with in a text being prepared by the International Institute for the Unification of Private Law (UNIDROIT). The law applicable to security and other rights in securities is not addressed in this Guide since it forms the subject of the Hague Convention on

the Law applicable to Certain Rights in Respect of Securities (The Hague, December 2002). The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by UNIDROIT and the Hague Conference, as well as relevant texts prepared by UNCITRAL, such as the United Nations Convention on the Assignment of Receivables in International Trade (New York, December 2001; herein after referred to as “the United Nations Assignment Convention”) and the UNCITRAL Legislative Guide on Insolvency Law. *[Note to the Working Group: In due course, the Working Group may wish to expand on this matter. Also a decision by the Working Group is pending as to whether the Guide will cover assets, such as promissory notes, checks, letters of credit, deposit accounts and intellectual property rights.]*

11. The Guide stresses the need to enable a physical or legal person to create security rights not only in its existing assets but also in its future assets (i.e. assets acquired or created after the execution of the security agreement), without requiring the parties to execute any additional documents or to take any additional action at the time such assets are acquired or created. In addition, the Guide recommends recognition of a security right in all assets of a person through a single security agreement (“all-asset security”, referred to in some legal systems as “enterprise mortgage” or “floating charge”).

12. The Guide also suggests that a broad range of obligations, monetary and non-monetary may be secured, and that both physical and legal persons may be parties to a secured transaction, including consumers, subject to consumer-protection laws. In addition, the Guide is intended to cover a broad range of transactions that serve security functions, including those related to possessory and non-possessory security rights, as well as transactions not denominated as secured transactions (retention of title, transfer of title for security purposes, assignment of receivables for security purposes, financial leases, sale and leaseback transactions and the like). *[Note to the Working Group: The Working Group may wish to consider the inclusion and the treatment of title-based security devices in the Guide. The Working Group may wish to consider in particular whether a modern secured transactions systems should include rules on title-based security devices and, if so, what types of rules on creation, publicity, priority, enforcement, insolvency and cross-border recognition.]*

13. The legal regime envisaged in the Guide is a purely domestic regime. The recommendations of the Guide are addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the mutual recognition of security rights (and title-based security devices, such as retention of title) validly created in other jurisdictions. This would represent a marked improvement over the laws currently in effect in many States, under which security rights often are lost once an encumbered asset is transported across national borders, and would go far toward encouraging creditors to extend credit in cross-border transactions (see A/CN.9/WG.VI/WP.9/Add.7, paras. 18-22 and 35).

14. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, purchasers and other transferees, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that creditors will accept such

a balanced approach, and will thereby be encouraged to extend low-cost credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately realize the economic value of the encumbered assets. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since this matter does not lend itself to unification.

15. In the same spirit, the Guide also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. Another concern is the potential ability of a secured creditor to exercise influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. Yet another concern is that in some cases secured creditors may take most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, some of whom are not in a position to bargain for a security right in those assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, suggests solutions.

16. The Guide builds on the work of UNCITRAL and other organizations. Such work includes: the United Nations Assignment Convention; the UNCITRAL Legislative Guide on Insolvency Law; the Convention on International Interests in Mobile Equipment, approved in November 2001; the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD General principles of a modern secured transactions law, completed in 1997; the study on Secured Transactions Law Reform in Asia, prepared by the Asian Development Bank in 2000; the OAS Model Inter-American Law on Secured Transactions, prepared in 2002; and the OHADA Uniform Act Organizing Securities, prepared in 1997 [...].

C. Terminology

17. This Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given to the term may differ. This approach is taken to provide readers with a common vocabulary and conceptual framework and to encourage harmonization of the law governing security rights. The following paragraphs therefore identify the principal terms used and the core meaning given to them in this Guide. The meaning of those terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms.

- (a) "Security right" means a consensual property right in movable property and fixtures that secures payment or other performance of one or more obligations.

- (b) “Purchase money security right” means a security right in an asset that secures the credit extended as the purchase price of the asset or other obligation incurred to acquire the asset. Purchase money security rights include, but are not limited to, retention of title and transfer of title for security purposes.
- (c) “Secured obligation” means the obligation secured by a security right.
- (d) “Secured creditor” means a creditor that has a security right.
- (e) “Debtor” means a person that owes performance of the secured obligation. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor).¹
- (f) “Grantor” means a person that creates a security right in one or more of its assets in favour of a secured creditor. The grantor may or may not be the debtor that owes performance of the secured obligation (see debtor).
- (g) “Security agreement” means an agreement between a grantor and a creditor that creates a right securing one or more of the debtor’s obligations.
- (h) “Encumbered asset” means property subject to a security right. In general, encumbered assets are divided into tangible and intangible property. Each of these two general types of asset comprises several sub-types.
- (i) “Tangibles” means all forms of corporeal movable property. Among the categories of tangibles are inventory, equipment, fixtures, negotiable instruments and negotiable documents.
- (j) “Inventory” means a stock of tangibles (other than tangibles such as negotiable instruments and negotiable documents) held for sale or lease in the ordinary course of business and also raw and semi-processed materials (work-in-process).
- (k) “Equipment” means tangibles (other than tangibles such as negotiable instruments and negotiable documents), other than inventory, used by a person in the operation of its business.
- (l) “Fixtures” means tangibles (other than tangibles such as negotiable instruments and negotiable documents), that can become subject to separate security rights even though they are so closely attached or associated with immovable property as to be treated as immovable property under the law of the State where the immovable property is located.
- (m) “Intangibles” means all movable property other than tangibles. Among the categories of intangibles are claims and receivables.

¹ For the sake of consistency with the UNCITRAL Legislative Guide on Insolvency Law, the term “debtor” is used in the chapter on Insolvency to mean a person who meets the requirements for the commencement of an insolvency proceeding (see A/CN.9/WG.V/WP.70, Introduction, sect. 2). However, where the security right is granted not by the debtor but by a third party on the basis of some contractual arrangement with the debtor, and both the debtor and the grantor are insolvent, the term “debtor” in the chapter on Insolvency means the grantor, since only in the insolvency of the grantor is the creditor a secured creditor with a proprietary right in the encumbered assets. In the debtor’s insolvency, the creditor is an unsecured creditor with a contractual claim against the debtor.

- (n) “Claim” means a right to the performance of a non-monetary obligation other than negotiable documents.
- (o) “Receivable” means a right to the payment of a monetary obligation.
- (p) “Proceeds” means whatever is received in respect of encumbered assets, including, but not limited to, amounts received upon sale, lease or other disposition, civil and natural fruits, dividends, insurance proceeds and claims arising from damage or loss, and tort or warranty claims.
- (q) “Priority” means the right of person to derive the economic benefit of its security right in an encumbered asset in preference to other persons having a security or other right in the same asset.
- (r) “Possessory security right” means a security right in encumbered assets in the possession of a secured creditor or a third party (other than the debtor or the third party grantor) holding the asset for the secured creditor.
- (s) “Non-possessory security right” means a security right in: (i) tangibles not in the possession of the secured creditor or a third party holding the tangibles for the benefit of the secured creditor, or (ii) intangibles.
- (t) “Insolvency court” means a judicial or other authority competent to control or supervise an insolvency proceeding.
- (u) “Insolvency estate” means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings.
- (v) “Insolvency proceedings” means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor’s business conducted according to the insolvency law.
- (w) “Insolvency representative” means a person or body responsible for administering the insolvency estate.
- (x) “Negotiable instrument” means an instrument that embodies a right to payment, such as a promissory note or a bill of exchange.
- (y) “Negotiable document” means a document that embodies a right for delivery of tangibles, such as a warehouse receipt or a bill of lading.
- (z) “Account debtor” means a person liable for payment of a receivable.
- (aa) “Buyer in the ordinary course of business” means a person who buys goods in the ordinary course from a person in the business of selling goods of that kind and without knowledge that the sale violates the security or other rights of another person in the goods.
- (bb) “Control” means the legal authority of a secured creditor to direct the disposition of encumbered assets without the need of any further consent or action by the grantor.

D. Examples of financing practices to be covered in the Guide

18. Set forth below are three short examples of the types of secured credit transactions that the Guide is designed to encourage, and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use, and an effective secured transactions regime must be sufficiently flexible to accommodate many existing modes of financing, as well as modes that may evolve in the future.

1. Inventory and equipment purchase-money financing

19. Businesses often desire to finance specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the goods. In other cases, the financing is provided by a lender instead of the seller. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller or lender is granted by agreement a security right in the goods sold to secure the repayment of the credit or loan. This type of financing is often referred to as purchase-money financing.

20. Here is an example of purchase-money financing: ABC Manufacturing Company (ABC) is a manufacturer of furniture with facilities located in State X and customers located in multiple States. ABC desires to purchase paint from Vendor A and steel tubing from Vendor B, and to lease certain manufacturing equipment from Lessor A, all of which will be used by ABC in manufacturing furniture.

21. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within thirty days of delivery to ABC, and ABC grants to Vendor A a security right in the paint until ABC pays the purchase price in full. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the steel tubing before it is delivered to ABC. ABC obtains a loan from Lender A to finance the purchase of the steel tubing from Vendor B, secured by a security right in the steel tubing. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the account as an additional security for the repayment of the loan.

22. Under the lease agreement with Lessor A, ABC leases the manufacturing equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a “finance lease”. Under some forms of finance lease, title to the leased property is transferred to the lessee automatically at the end of the lease term. A finance lease is to be distinguished from a lease (often referred to as an “operating lease”) under which the lessee does not have an option to purchase the leased property for a nominal price, title to the leased property is not transferred to the lessee automatically at the end of the lease term, or the leased property has no remaining useful life at the end of the lease.

2. Receivable and inventory revolving loan financing

23. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

24. One highly effective method of providing such working capital is a revolving loan facility. Under this type of facility, loans secured by the borrower's existing and future receivables and inventory are made from time to time at the request of the borrower to fund the borrower's working capital needs (see also A/CN.9/WG.VI/WP.11/Add.2, para. 12). The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower.

25. Here is an example of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving line of credit to ABC to finance this process. Under the line of credit, ABC may obtain loans from time to time in an aggregate amount of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the account debtors) and of up to 50 per cent of the value of its inventory that Lender B deems acceptable for borrowing (based upon criteria such as its type and quality). ABC is expected to repay these loans from time to time as it receives payments from its customers. The line of credit is secured by all of ABC's existing and future receivables and inventory.

3. Term loan financing

26. Businesses often need financing for large, non-ordinary course expenditures, such as the construction of a new manufacturing plant or the acquisition of a business. In these situations, businesses generally seek financing that is not repayable until long after construction is completed. This type of loan facility is typically referred to as a term loan. In many cases, a term loan is amortized in accordance with an agreed-upon payment schedule.

27. For businesses that do not have strong, well-established credit ratings, term loan financing will generally be available only if the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, real property is the only type of asset that typically secures term loan financing. However, many businesses, particularly newly-established businesses, do not own any real property and, therefore, may not have access to term loan financing. In other States, term loans secured by other assets, such as equipment and even intellectual property, are common.

28. Here is an example of this type of financing: ABC desires to expand its operations and construct a new manufacturing plant in State Y. ABC obtains a loan from Lender C to finance such construction. The loan is repayable in equal monthly instalments over a period of ten years and is secured by the new manufacturing plant, including all equipment that is either located in the plant at the time the plant begins operating or is thereafter acquired by ABC.

II. Key objectives of an effective and efficient secured transactions regime

29. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime.

A. Promote secured credit

30. The primary overall objective of the Guide is to promote low-cost secured credit for parties in jurisdictions that adopt legislation based on the Guide's recommendations, thereby enabling such parties and the economy as a whole to obtain the economic benefits that flow from access to such credit (see para. 2).

B. Allow a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions

31. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (i) permitting a broad range of assets to serve as encumbered assets (including present and future inventory, equipment and receivables); (ii) permitting a broad range of obligations (including future and conditional obligations) to be secured by security rights in encumbered assets; and (iii) extending the benefits of the regime to a broad array of debtors, creditors and credit transactions.

C. Obtain security rights in a simple and efficient manner

32. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include: eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or actions by the parties.

D. Recognize party autonomy

33. Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the Guide stresses the need to keep mandatory laws to a minimum so that parties may tailor their credit transactions to their specific needs. At the same time, the Guide takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

E. Provide for equal treatment of creditors

34. Because healthy competition among all potential creditors is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to various creditors, including banks and other financial institutions, as well as domestic and non-domestic creditors.

F. Validate non-possessory security rights

35. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with mechanisms for publicizing the existence of such security rights.

G. Encourage responsible behaviour by enhancing predictability and transparency

36. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns.

H. Establish clear and predictable priority rules

37. A security right will have little or no value to a creditor unless the creditor is able to ascertain its priority in the property relative to other creditors (including an insolvency representative). Thus, the Guide proposes the establishment of a system for registering public notices with respect to security rights and, based on that system, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

I. Facilitate enforcement of creditor's rights in a predictable and efficient manner

38. A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner. Thus, the Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

J. Balance the interests of the affected persons

39. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

K. Harmonize secured transactions laws

40. Adoption of legislation based on the recommendations contained in the Guide will result in harmonization of secured transactions laws (through the adoption of similar substantive laws which will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade and the movement of goods and services across national borders.
