United Nations A/CN.9/WG.VI/WP.11/Add.2

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

Contents

* 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.

V.04-50875 (E)

IV. Creation

A. General remarks

1. Introduction

1. This chapter deals with issues relating to the creation of consensual security rights (statutory or judicial rights are mentioned in this Guide only in the context of conflicts of priority; see A/CN.9/WG.VI/WP.9/Add.3, paras. 44-53). Before dealing with the issues relating to the security agreement (see sect. A.3) and other proprietary requirements for the creation of an effective security right (see sect. A.4), this chapter outlines the two basic elements of both, namely the obligations to be secured (see sect. A.2.a) and the assets to be encumbered (see sect. A.2.b)

2. Additional requirements for the effectiveness of a security right against third parties are discussed in chapter VI on priority as they relate to ranking of creditors with a security right in the same asset. Matters related to the effectiveness of a security right in the case of insolvency are discussed in chapter IX on insolvency.

2. Basic elements of a security right

(a) Obligations to be secured

i. Connection between security and secured obligation

3. Security rights are accessory to and dependent upon the obligation they secure. This means that the validity and the terms of the security agreement depend on the validity and the terms of the agreement giving rise to the secured obligation. In particular, with respect to revolving loan transactions, a security right is accessory in the sense that, while it can secure future advances and fluctuating obligations (see para. 12), it cannot be enforced if there is no advance on the loan and cannot surpass the amount of the obligation owed at the time of enforcement.

ii. Limitations

4. In some countries, non-possessory security rights may relate only to specific types of obligations described in legislation (e.g. loans for the purchase of automobiles or loans to farmers). In other countries with a general regime for possessory security rights only or for both possessory and non-possessory security rights, no such limitations exist. Such a comprehensive approach has the potential of spreading the main benefits derived from secured financing (i.e. greater availability of credit and at a lower cost) to the parties to a wide range of transactions. In addition, such an approach enhances certainty, consistency and equal treatment of all debtors and secured creditors. To the extent such special regimes are necessary for specific socio-economic reasons, adverse effects may be minimized if such regimes are established in a clear and transparent way and are limited to a narrow range of transactions.

iii. Varieties of obligations

a. Monetary and non-monetary obligations

5. Both monetary obligations and non-monetary obligations that are convertible to monetary obligations may be secured.

b. Type of obligation

6. Unless there is a special regime for security rights in specific types of obligations (e.g. for loans by pawnbrokers), it is not necessary to list in legislation all the types of obligations that can be secured. An exhaustive list would be impossible. However, an indicative list would typically include obligations arising from loans and the purchase of goods, including inventory and equipment, on credit.

c. Future and conditional obligations

7. Legal systems differ on the definition of future obligations. In some systems, future obligations are the obligations that have not been contracted for (this is the approach of the United Nations Assignment Convention; see art. 5 (b)). In other systems, even obligations that have been contracted for but are not due at the time of the security agreement (because the loan has not been advanced yet or the loan involves a revolving loan facility; see A/CN.9/WG.VI/WP.11/Add.1, para. 24) are treated as future obligations.

8. The distinction between present and future obligations is significant in those legal systems in which, for reasons of certainty and debtor protection, future obligations may not be capable of being secured or may be secured only up to a maximum amount. As a result, in such jurisdictions, debtors may not be able to benefit from certain transactions, such as revolving loan facilities. In other legal systems, future obligations may be freely secured. In those systems, one security agreement is sufficient to cover both present and future obligations. As a result, each extension or increase of credit does not require that the corresponding security right be modified or even newly created, and this has a positive impact on the availability and the cost of credit. While a security right may be created in a future obligation, it cannot be enforced until the obligation arises and becomes due.

9. Obligations subject to a condition subsequent are treated as present obligations, while obligations subject to a condition precedent are normally treated as future obligations.

iv. Description

a. Specific description and maximum amount

10. In some legal systems, it is necessary for the parties to describe the secured obligations in their agreement in specific terms or to set a maximum limit to the amount of the secured obligations. The assumption is that such description or limit is in the interest of the debtor since the debtor would be protected from overindebtedness and would have the option of obtaining additional credit from another party. However, such requirements may result in limiting the amount of credit available and thereby in increasing the cost of credit. In particular, limits as to the amount to be secured imposed by law are unavoidably arbitrary, cannot address

the needs of each individual debtor and would need to be adjusted periodically as they are bound to become outdated.

11. For all those reasons, many legal systems do not require specific descriptions of the secured obligations and allow parties to negotiate freely the amount to be secured, including all sums owed by the debtor to the secured creditor ("all sums clauses"). In those legal systems, the secured obligation must be determined or determinable on the basis of the security agreement whenever a determination is needed (as is the case, for example, when the secured creditor enforces its security rights). All sums clauses are based on the assumption that the secured creditor cannot claim from the encumbered assets more than it is owed and that, if the obligation is fully secured, better credit terms are likely to be offered to the debtor by the secured creditor (see also A/CN.9/WG.VI/WP.9/Add.2, para. 53).

b. Fluctuating amounts

12. Modern financing transactions often no longer involve a one-time payment but instead frequently foresee advances being made at different points of time depending on the needs of the debtor (for example, revolving credit facilities for the debtor to buy inventory; see A/CN.9/WG.VI/WP.11/Add.1, para. 24). Such financing may be conducted on the basis of a current account, the balance of which fluctuates daily. If the amount of the secured obligation were to be reduced by each payment made, lenders would be discouraged from making further advances unless they were granted additional security. This would be highly inefficient as it would add to the cost and the time necessary for the debtor to acquire new goods required for the conduct of its business.

c. Amounts in foreign currency

13. The amount of the secured obligation may be expressed in any currency. Where there is debtor default (or insolvency) and disposition of the encumbered assets, it may be necessary to convert the proceeds from the disposition of the encumbered assets so that the secured obligation and the encumbered assets are expressed in the same currency. This issue, however, is typically left to the contract from which the secured obligation arises and to the applicable law (e.g. in the absence of an agreement, the exchange rate prevailing at the place of enforcement or insolvency proceedings will prevail).

(b) Assets to be encumbered

i. Object of the security right

14. The object of the security right may be the debtor's or other grantor's ownership or other limited right (e.g. a right of use or lease) in the encumbered assets (including future assets; see paras. 16-18). A principle that is recognized in most legal systems is that the debtor cannot grant to the secured creditor more rights than the debtor has or may acquire in the future. Apart from tangibles (e.g. goods), intangibles (e.g. receivables and other rights) are of growing importance as objects of security rights.

ii. Limitations

15. In some legal systems, special laws for specific types of non-possessory security rights introduce limitations as to the types of asset that may serve as security or as to the part of the value of assets that may be encumbered. Such limitations, which are usually intended to protect debtors, prevent debtors from utilizing the full value of their assets to obtain credit. Therefore, the benefits and the negative impact of such limitations need to be carefully weighed. Examples of limitations justified for public policy reasons may include wages and pensions under a certain minimum amount, as well as household goods (unless they secure payment of their own purchase price).

iii. Future assets

16. The term "future" covers both assets that already exist at the time of the conclusion of the security agreement but do not belong to the debtor or other grantor (or the debtor or other grantor cannot dispose of them) and assets that, at that point of time, do not even exist.

17. In some countries, future assets may not be used as security. This approach is partly based upon technical notions of property law (e.g. what does not exist cannot be transferred or encumbered). It is also based on the concern that allowing broad dispositions of future assets may inadvertently result in overindebtedness and in making the debtor excessively dependent on one creditor, preventing the debtor from obtaining additional secured credit from other sources (see para. 24). Yet another argument offered for not permitting the creation of security rights in future assets is that the possibility that unsecured creditors of the debtor will obtain satisfaction for their claims may be significantly reduced. However, technical notions of property law should not be invoked to pose obstacles to meeting the practical need of using future assets as security to obtain credit. In addition, business debtors can protect their own interests and do not need statutory limitations on the transferability of rights in future assets. Moreover, permitting future assets to be encumbered makes it possible for debtors with insufficient present assets to obtain credit, which is likely to enhance their business and benefit all creditors, including unsecured creditors.

18. In other countries, the parties may agree to create a security right in a future asset. The disposition is a present one but it becomes effective as to the future asset only when the debtor or other grantor becomes the owner of the asset or the asset comes into existence. The United Nations Assignment Convention takes this approach (see art. 8 (2) and art. 2 (a)). Permitting the use of future assets as security for credit is important, in particular, for securing claims arising under revolving loan transactions (see para. 12) by a revolving pool of assets. Assets to which this technique is typically applied include inventory, which by its nature is to be sold and replaced, and receivables, which after collection are replaced by new receivables. The main advantage of this approach is that one security agreement may cover a changing pool of assets that fit the description in the security agreement. Otherwise, it would be necessary to continually amend security agreements or enter into new ones, a result that could increase transaction costs and decrease the amount of credit available, in particular on the basis of revolving credit facilities.

iv. Assets not specifically identified

19. In some legal systems, the encumbered assets need to be specifically identified. While such a requirement is intended to protect the debtor from excessive limitations, it also limits availability of credit since specific identification may not be possible for assets such as inventory and, to some degree, receivables. To address this issue, many countries have developed rules that allow the parties to describe the assets to be encumbered only in general terms. The specific identification, generally required, is transposed from the individual items to an aggregate, which in turn has to be generally identified. In some legal systems, even a description referring to all assets, present and future, is sufficient (e.g. "all my assets, presently owned and hereafter acquired"). In some of those legal systems, such a generic identification of encumbered assets is not allowed with respect to assets of consumers or even individual small traders.

v. All-asset security

20. In some legal systems, for the same reasons future assets or assets not specifically identified may not be encumbered (see paras. 16-18), a debtor is not permitted to grant security in all of its assets. In other legal systems, debtors are permitted to grant a security right in all of their assets up to a certain percentage of their total value. Such limitations, which are intended to provide some protection for unsecured creditors, are bound to limit the credit available and increase the cost of credit.

21. To enhance the availability of secured credit, some legal systems permit the creation of a non-possessory security right in all of the assets of a debtor, including tangible and intangible, movable and immovable (although different rules may apply to security in immovables), and present and future assets. The most essential aspects of such all-asset security are that it covers all assets of a debtor and the debtor has the right to dispose of certain of its encumbered assets (such as inventory) in the ordinary course of its business (while the security is extended automatically to the proceeds of the assets disposed). Under most legal systems, such a right to dispose of encumbered assets without affecting the security right is acknowledged. However, in some legal systems, dispositions of encumbered assets by the debtor, although authorized by the creditor, are regarded as irreconcilable with the idea of a security right.

22. Related to, though distinguishable from, the all-asset security is the issue of overcollateralization, which arises in situations where the value of the encumbered assets significantly exceeds the amount of the secured obligation. While the secured creditor cannot claim more than the secured obligation plus interest and expenses (and perhaps damages), overcollateralization may create problems. The debtor's assets may be encumbered to an extent that makes it difficult or even impossible (at least in the absence of a subordination agreement between creditors) for the debtor to obtain a second-ranking security from another creditor. In addition, executions by the debtor's unsecured creditors may be precluded or at least be made more difficult (unless there is excess value). A solution developed by courts in some countries is to declare any security right grossly in excess of the secured obligation plus interest, expenses and damages void or to grant the debtor a claim for release of such excess security. This solution could work in practice, if a commercially adequate margin

may be determined and granted to the secured creditor, which may not be easy in all cases.

23. In some countries, all-asset security takes the form of so called "enterprise mortgages". An enterprise mortgage may comprise all assets of an enterprise (including, in some countries, even immovables). It may cover, for example, incoming cash, new inventory and equipment, as well as future assets of an enterprise, while present assets that are disposed of in the ordinary court of business are released. The main advantage of an enterprise mortgage is that it allows an enterprise that has more value as a whole to obtain more credit and at a lower cost. An interesting feature of some forms of enterprise mortgage is that upon enforcement by the secured creditor and upon execution by another creditor, an administrator can be appointed for the enterprise. This may assist in avoiding liquidation and in facilitating reorganization of the enterprise with beneficial effects for creditors, the workforce and the economy in general. In practice, however, administrators appointed by the secured creditor may favour the secured creditor. This problem may be mitigated to some extent if the administrator is appointed and supervised by a court or other authority. This feature of an enterprise mortgage may be usefully expanded to all-asset security in the sense that the administrator could be appointed by agreement of the debtor and the secured creditor or by the court and be responsible for enforcement in and outside insolvency. [*Note to the Working Group: The Working Group may wish to consider whether such an administrator should act in the interest of the secured creditor or in the interest of all creditors* (*see A/CN.9/543, para. 19*).]

24. Enterprise mortgages may present certain disadvantages in practice. One disadvantage is that the secured creditor usually is or becomes the enterprise's major or even exclusive credit provider and this may affect competition among credit providers and thus negatively affect the availability and the cost of credit to the extent that other creditors are unprotected (although competition is not necessarily precluded since a single major credit provider may offer particularly competitive credit terms). In order to address this problem, some countries introduced limitations on the scope of enterprise mortgages, preserving a percentage of the value of the enterprise for unsecured creditors in the case of insolvency. However, such limitations may have an adverse impact on the availability of credit by effectively reducing the amounts of assets available to serve as security (see A/CN.9/WG.VI/WP.9/Add.6, para. 34). Another possible disadvantage of enterprise mortgages is that, in practice, the holder of the mortgage may fail to sufficiently monitor the enterprise's business activities and to actively participate in reorganization proceedings since the mortgagee is amply secured. In order to counterbalance the mortgagee's overly strong position, the debtor-enterprise may be given a claim for the release of grossly excessive security (see para. 22).

25. In other countries, all-asset security takes the form of a so called "floating charge" that is merely a potential security right with a right for the debtor to dispose of certain of the encumbered assets (such as inventory) in the ordinary course of business. Dispositions are barred as of the time the debtor is in default, when the floating charge "crystallizes" to become a fully effective "fixed" charge. Once a legal system permits the creation of non-possessory security rights in all assets of a debtor while the debtor is allowed to dispose of certain of the assets in the ordinary

course of its business, there is no need to preserve the construction or the terminology of enterprise mortgages or floating charges.

vi. Fixtures, accessions and commingled goods

26. A movable may be attached to an immovable (and become a fixture) or to another movable in such a way that its identity is not lost (and become an accession) or in a way that its identity is lost (and become commingled). In all these cases, the question arises as to whether a security right, to which the original movable was subject before attachment or commingling, is preserved.

27. In some countries, a security right may be created in movables that are fixtures (without preventing the creation of a security right under real property law) or accessions or may continue in movables that have become fixtures or accessions regardless of the cost or difficulty of removing the fixture or accession from the property to which it was attached and regardless whether the fixture or accession has become an integral part of that property. In those countries, whether the fixture or accession may be identified and readily removed without damage from the property to which it was attached is relevant for determining the priority among competing claimants (see chapter VI on priority). In other countries that do not distinguish between creation and priority, this is an issue of creation.

28. As to commingled goods, in some countries, if encumbered assets become commingled with other assets in a way that the encumbered assets are no longer identifiable, a security right may be converted into a security right in the product or mass (as to priority of competing claims in commingled goods, see chapter VI on priority).

vii. Liability for damage caused by the encumbered assets

29. While liability for damage caused by encumbered assets (as a result of breach of contract or tort) is not a secured transactions issue, it is important to be addressed since it may have an impact on the availability and the cost of credit. A particularly important issue is liability for environmental damage caused by assets subject to possessory or non-possessory security rights since the monetary consequences and the prejudice to the reputation of the lender may substantially exceed the value of the encumbered assets. Some laws expressly exempt secured creditors from liability, while other laws limit such liability under certain conditions (e.g. where the secured creditor has no possession or control of the encumbered asset). When no such exemptions from or limitations of liability exist, the risk may be too high for a lender to extend credit. Where insurance is available, it is bound to substantially increase the cost of credit to the debtor.

(c) Proceeds

i. Introduction

30. When encumbered assets are sold, leased, licensed, exchanged or otherwise disposed of during the time in which the obligation they secure is outstanding, the debtor typically receives, in exchange for those assets, cash, tangible property (e.g. goods or negotiable instruments) or intangible property (e.g. receivables or other rights). Such cash or other tangible or intangible property is referred to in many legal systems as “proceeds” of the encumbered assets. In some cases, the

proceeds of the original encumbered assets may generate other proceeds when the debtor disposes of the original proceeds in return for other property. Such proceeds are sometimes referred to as "proceeds of proceeds".

31. In other situations, encumbered assets may generate other property for the debtor even without a disposition of these assets. Such property may include, for example, interest or dividends on financial assets, new-born animals and fruits or crops. Property generated in this way by encumbered assets is referred to in some legal systems as "civil fruits" or "natural fruits".

32. In some legal systems, civil or natural fruits are clearly distinguished from proceeds arising from disposition of encumbered assets and are made subject to different rules. The difficulty in identifying proceeds of disposition and the need to protect rights of third parties in proceeds is often cited to justify this approach. Other legal systems do not distinguish between civil or natural fruits and proceeds of disposition and subject both to the same rules. The difficulty in distinguishing between civil or natural fruits and proceeds, the fact that both civil or natural fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets are among the reasons mentioned to justify this approach.

33. A legal system governing security rights must address two distinct questions with respect to proceeds of disposition and civil or natural fruits (hereinafter referred to collectively as "proceeds", unless otherwise indicated). The first issue is whether the secured creditor retains the security right if the encumbered asset is transferred from the debtor to another person in the transaction that generates the proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.9/Add.3, para. 67).

34. The second issue concerns the secured creditor's rights with respect to the proceeds. A legal system governing security rights should provide clear answers to certain key questions pertaining to the secured creditor's rights in proceeds (see paras. 35-41).

ii. Existence of security rights in proceeds

35. The justification for a right in proceeds lies in the fact that, if the secured creditor does not obtain such a right, its rights in the encumbered assets could be defeated or reduced by a disposition of those assets and its expectation to receive any income generated by the assets would be frustrated. If the legal system did not permit the creation of a security right in proceeds upon disposition of encumbered assets, it would not adequately protect the secured creditor against default and thus the value of encumbered assets as a source of credit would diminish. This result, which would have a negative impact on the availability and the cost of credit, would be the same even if the security right in the original encumbered assets were to survive their disposition to a third party. The reason for this result lies in the possibility that a transfer of the encumbered assets may increase the difficulty in locating the assets and obtaining possession thereof, increase the cost of enforcement and reduce the value of the assets.

iii. Circumstances in which rights in proceeds may arise

36. A right in proceeds typically arises where the encumbered assets are disposed of because the proceeds replace the original encumbered assets as assets of the debtor. In systems that treat civil or natural fruits as proceeds, a right in such

proceeds may arise even if no transaction takes place with respect to the encumbered assets (e.g. dividends arising from stocks) because this is consistent with the expectations of the parties.

iv. Personal or proprietary nature of rights in proceeds

37. If the secured creditor's right in proceeds is a proprietary right, the secured creditor will not suffer a loss by reason of a transaction or other event, since a proprietary right produces effects against third parties. On the other hand, granting the secured creditor a proprietary right in proceeds might result in frustrating legitimate expectations of parties who obtained security rights in those proceeds as original encumbered assets. However, in legal systems in which creation is distinguished from priority this result would occur only if the creditor with a proprietary right in proceeds had priority over the creditors with a right in proceeds as original encumbered assets and such priority is determined on the basis of time of filing of a notice about the transaction in a public register. Thus, in those systems, potential financiers are forewarned about the potential existence of a security right in assets of their potential borrower (including proceeds of such assets) and can take the necessary steps to identify and trace proceeds, and to obtain inter-creditor subordination agreements where appropriate.

v. Identification of proceeds

38. When property constituting proceeds of encumbered assets is not kept separately from other assets of the debtor, the question arises as to whether the security right in the proceeds is preserved. The answer to this question usually depends on whether the property constituting proceeds is identifiable. Proceeds in the form of goods kept with other assets of the debtor can be identified as proceeds in any manner that is sufficient to establish that the goods are proceeds. When goods that are proceeds are so mixed with other goods that their separate identity is lost in a product or mass (for example, through manufacturing or production as in the flour that becomes part of baked goods), a security right in the product or mass may be provided by the legal system as a substitute for the security right in the proceeds.

39. If the property constituting proceeds is intangible (rather than goods), such as receivables or balances in deposit accounts, and is not maintained separately from the debtor's other assets of the same type, such intangible property may be identified as proceeds if they can be traced to the original encumbered assets on the basis of tracing rules. Examples of tracing rules include: (i) "first-in, first-out" ("FIFO"), which assumes that the first property to become part of a commingled mass is the first property withdrawn from the mass; (ii) "last-in, first-out" ("LIFO"), which assumes that the last property to become part of a commingled mass is the first property withdrawn from the mass; and (iii) the "lowest intermediate balance rule" ("LIBR"), which assumes, to the extent possible, that withdrawals from the commingled mass are not proceeds of the encumbered assets (for priority in proceeds, see A/CN.9/WG.VI/WP.9/Add.3, paras. 65-73).

vi. Basis of the rights in proceeds

40. In some legal systems, the law extends security rights in encumbered assets to proceeds and to proceeds of proceeds through default rules applicable in the absence of an agreement to the contrary. In other legal systems, such a statutory right in

proceeds does not exist, but parties may take security rights in all types of asset. In such systems, parties may be free to provide, for example, that a security right is created in substantially all of the debtor's assets (cash, inventory, receivables, negotiable instruments, securities and intellectual property rights). In such a way, the proceeds themselves become original encumbered assets and are covered by the security right of the creditor even without a legal rule automatically providing a right in proceeds. In some of those legal systems, parties may extend by agreement certain title-based security rights (e.g. retention of title) to proceeds (see A/CN.9/WG.VI/WP.9/Add.1, para. 36; see also para. 61 below).

vii. Proceeds of proceeds

41. If there is a right in proceeds of encumbered assets, it should extend to proceeds of proceeds. If the secured creditor loses its right in the proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case if there were no rights in proceeds (see para. 35).

3. Security agreement

(a) Functions

42. The security agreement may fulfil several functions, including that it may: (i) provide the legal basis for granting a security right; (ii) establish the connection between the security right and the secured obligation; (iii) generally regulate the relationship between the debtor or other grantor and the secured creditor (for pre-default rights, see A/CN.9/WG.VI/WP.9/Add.4; for post-default rights, see A/CN.9/WG.VI/WP.9/Add.5 and A/CN.9/WG.VI/WP.9/Add.6); and (iv) minimize the risk of disputes as to its contents and of manipulation after default. While the security agreement may be a separate agreement, often it is contained in the underlying financing contract or other similar contract (e.g. contract of sale of goods on credit) between the debtor and the creditor.

(b) Parties

43. In most cases, the security agreement is concluded between the debtor as grantor of the security right and the creditor as the secured party. Occasionally, if a third person grants the security for the benefit of the debtor, this person becomes a party to the agreement instead of or in addition to the debtor. In the case of large loans granted collectively by several lenders (especially in case of syndicated loans), a third party, acting as agent or trustee for the lenders, may hold security rights on behalf of all of the lenders. Security agreements may be tailored to cover each of these situations. While some systems introduce limitations (e.g. only enterprises may grant an enterprise mortgage), in other systems both natural and legal persons may be parties to a security agreement.

(c) Minimum contents

44. Legal systems differ as to the requirements for an effective security agreement. However, the security agreement typically has to identify the parties and reasonably describe the obligation to be secured and the assets to be encumbered. Whether or not legislation lists these matters as the minimum contents of a security agreement, failure to deal with them in the security agreement may result in disputes

concerning the scope of the assets encumbered and the obligation secured, unless the missing elements may be established through other means.

45. The parties may clarify in the security agreement additional matters, such as the duty of care on the part of the party in possession of the encumbered assets and representations with respect to the encumbered assets. In the absence of an agreement, default rules may apply to clarify the relationship between the parties (for pre-default issues, see A/CN.9/WG.VI/WP.9/Add.4; for post-default issues, see A/CN.9/WG.VI/WP.2/Add.9 and A/CN.9/WG.VI/WP.9/Add.6).

(d) Formalities

46. Legal systems differ as to form requirements for security agreements and their function. In particular, some legal systems do not require that there be a written security agreement, while other legal systems require a simple writing, a signed writing, a notarized writing or an equivalent court or other document (as is the case with enterprise mortgages). Normally, written form performs the function of a warning to the parties of the legal consequences of their agreement, of evidence of the agreement and, in the case of authenticated documents, of protection for third parties against fraudulent antedating of the security agreement. Written form may also be a condition of effectiveness between the parties or as against third parties or of priority among competing claimants. It may also be a condition for obtaining possession of the encumbered assets or for invoking the security agreement in the case of enforcement, execution or insolvency.

47. In some legal systems, a certification of the date by a public authority is required for possessory security rights, with the exception of small-amount loans where proof even by way of witnesses is permitted. While such certification may address the problem of fraudulent antedating, it may raise a problem with respect to the time and cost required for a transaction. In other legal systems, a certified date or authentication of the security agreement is required for various types of non-possessory security (see, for example, articles 65, 70, 94 and 101 of the OHADA Act). In some of those systems, such certification is required instead of publicity by registration. Where, however, registration is necessary, an additional certification of the date of the security agreement is not required.

48. In the interest of saving time and cost, mandatory form requirements need to be kept to a minimum. A simple writing (including, for example, general terms and conditions or a bill) may be sufficient as long as it clearly indicates the intention of the grantor to grant a security right. It could be in the form of an electronic data message (i.e. “information generated, sent, received or stored by electronic, optical or similar means, including, but not limited to, electronic data interchange (EDI), electronic mail, telegram, telex or telecopy” see art. 2 (a) of the UNCITRAL Model Law on Electronic Commerce), which includes a record created and stored but not communicated (see para. 30 of the Guide to Enactment of the Model Law). Alternatively, the matter may be left to the general law of obligations and to the parties to the security agreement.

49. For security in all assets of a debtor or cases where the security agreement can serve as sufficient title for execution (see para. 46), a more formal document may be necessary. Alternatively, in such a case, no writing may be required but the secured

creditor will have to bear the burden of establishing the contents and the date of the security agreement.

(e) Effects

50. In some countries, in which property rights are only those that can be asserted against all persons, a fully effective security right only comes into being upon conclusion of the security agreement and completion of an additional act (delivery of possession, notification, registration or control; see para. 57).

51. In other countries, a distinction is drawn between effects as between the parties to the security agreement and effects as against third parties. In those countries, the security comes into existence upon conclusion of the security agreement but only between the contracting parties. An additional act is required for the security to take effect against third parties and serves as a basis for determining priority. The main advantage of this approach is that, by introducing the notion of priority, it makes it possible for debtors to offer the same assets as security to more than one creditor (up to the full value of the assets) and makes possible the ranking of several creditors (see A/CN.9/WG.VI/WP.11/Add.1, para. 8 and A/CN.9/WG.VI/WP.9/Add.2, paras. 7-14).

4. Proprietary requirements

(a) Ownership, limited property right, right of disposition

52. In most legal systems, the grantor of the security (who normally is the debtor but may also be a third party) has to be the owner of the assets to be encumbered or have some limited proprietary right in the assets (see para. 14). In other legal systems, it is sufficient if the grantor has the power to dispose of the assets (but no ownership). With respect to future assets, it suffices if the grantor becomes the owner or obtains the power of disposition at a future time (see paras. 16-18).

53. Where the grantor does not have the ownership or the power to dispose of the assets, the question arises whether the secured creditor can nevertheless acquire the security right in good faith. In some legal systems, the creditor acquires the security right if its belief that the grantor has ownership, a limited property right or the power to dispose of the assets is supported by objective criteria (e.g. the grantor is registered as the owner of the assets to be encumbered or holds them and transfers possession thereof to the creditor). In other countries an additional element is that the creditor has or is about to extend credit to the debtor.

(b) Contractual restrictions of right of disposition

54. In some countries, effect is given to contractual restrictions on dispositions in order to protect the interest of the party in whose favour the restriction is agreed upon. In other countries, no effect or only a limited effect is given to contractual restrictions of dispositions so as to preserve the grantor's freedom of disposition, in particular if the person acquiring a right in an asset is not aware of the contractual restriction.

55. The United Nations Assignment Convention takes a similar approach to support transferability of receivables, which is in the interest of the economy as a whole. Under article 9, paragraph 1, of the Convention, an assignment is effective

despite a contractual restriction on assignment agreed upon between the assignor ("debtor" in the terminology of the Guide) and the debtor ("account debtor" in the terminology of the Guide). However, the effect of this provision is limited in two ways. Firstly, its application is limited to trade receivables broadly defined (see art. 9, para. 3); and secondly, if such a contractual restriction is valid under law applicable outside the Convention, article 9 does not invalidate it as between the assignor and the debtor (see art. 9, para. 2). The debtor is free to claim damages from the assignor for breach of contract, if such a claim exists under law applicable outside the Convention but may not raise this claim against the assignee by way of set-off (see art. 18, para. 3). In addition, mere knowledge of the existence of the restriction on the part of the assignee ("secured creditor" in the terminology of the Guide) is not enough for the avoidance of the contract from which the assigned receivable arises (see art. 9, para. 2).

56. This approach promotes receivables financing transactions since it relieves the assignee (i.e. the secured creditor) of the burden of having to examine the contracts from which the assigned receivables arose, in order to ascertain whether transfer of the receivables has been prohibited or made subject to conditions. Otherwise, lenders would have to examine a potentially large number of contracts, which may be costly or even impossible (e.g. in the case of future receivables).

(c) Transfer of possession, control, notification, registration

57. In some countries, in addition to the security agreement some other act is required for a security right to be created (transfer of possession, control, notification and registration). In other countries, the security agreement is sufficient to create the security right as between the grantor and the secured creditor, while an additional act is required for the effectiveness of the security right as against third parties. What that act might be varies from country to country, and even within individual countries, according to the type of security right involved (see A/CN.9/WG.VI/WP.9/Add. 2 and 3).

5. Title-based security devices

58. Certain agreements relating to title may serve security purposes. Such devices include retention of title, transfer of title for security purposes, assignment for security purposes, as well as sale and resale, sale and leaseback, hire-purchase and financial leasing transactions.

59. In legal systems with comprehensive secured transactions laws, title-based devices that serve security purposes are generally created in the same way as any other security right (they are either replaced by a uniform notion of security right or while their various terms are preserved their creation and effects are made subject to the rules applicable to security rights). In some of these legal systems, in view of the importance of suppliers of goods and materials for the economy, a policy decision is made to grant them a special priority status (see A/CN.9/WG.VI/WP.9/Add.2, para. 22). Any person financing the acquisition of goods may be granted such a right, whether it is a supplier or a financing institution. This approach is based on the need to promote competition between suppliers of goods on credit and financing institutions in view of the beneficial impact of such competition on the availability and the cost of credit (see A/CN.9/WG.VI/WP.9/Add. 3, para. 29).

60. In other legal systems, title-based devices are in essence the only or the main non-possessory security rights and are subject to various statutory and case law rules. Such legal systems differ widely in several respects. In some systems, only retention of title is subject to a specific regime, while transfer of title in goods and the assignment of receivables for security purposes are subject to the same rules governing the creation of security rights.

(a) Retention of title

61. Legal systems that treat title-based devices as non-security devices differ widely with respect to the requirements for the creation and the economic importance they attach to retention of title. In some systems, retention of title is used widely and is effective as against all parties, while in other systems it is insignificant and is generally ineffective or at least as against the administrator in the buyer's insolvency. One point on which many legal systems converge is that mainly simple retention of title is treated as a genuine title device, while all sums clauses, proceeds and products retention of title clauses are treated as true security devices (for the various types of retention of title clauses, see A/CN.9/WG.VI/WP.9/Add.1, paras. 36 and 37). Another point on which many legal systems that treat retention of title as a genuine title device converge is that only the seller may retain title, while another lender may obtain the retention of title only if it receives an assignment of the outstanding balance of the purchase price. Countries that follow this approach wish to protect suppliers of goods on credit over institutions financing the acquisition of goods in view of the importance of suppliers of goods (manufacturers and distributors) for the economy and the dominant position of financing institutions in credit markets.

62. In some legal systems, retention of title derives from a clause in the sales agreement, which may be concluded even orally or by reference to printed general terms. In other systems a writing, a certain date or even registration may be required. In some systems, if goods subject to retention of title are commingled with other goods, the retention of title is extinguished, while in a few other systems the retention of title is preserved as long as the same or equivalent goods are found in the hands of the buyer. In some systems, retention of title is preserved even if the goods are processed in a new product or the proceeds are commingled with other assets, while in other systems retention of title cannot be extended to new products or commingled proceeds. In some systems, a new buyer can acquire ownership of the goods if the initial buyer has the right to resell the goods, while in other systems the new buyer may acquire ownership even if the initial buyer does not have the right to resell the goods but only if the new buyer has no actual knowledge of the retention of title by the initial seller. In a few systems, courts have recognized that the buyer acquires an expectancy of ownership, which is treated as equivalent to ownership. Thus, the buyer has the right to resell the goods or to grant a security right in the goods (the buyer's expectancy of ownership is part of the buyers estate in the case of insolvency).

(b) Transfer of title and assignment of receivables for security purposes

63. Legal systems differ on the terminology used and the requirements for the creation and effects of fiduciary transfers of title for security purposes. In some legal systems, a security transfer of title is void as against third parties or even as

between the transferor and the transferee. In other legal systems, while a security transfer of title is effective, it is not widely used in view of the existence of other non-possessory security rights. In most of the legal systems that recognize the security transfer of title, its creation and effects, or at least its major effects, are subject to the same rules applicable to secured transactions in general or at least in the case of the transferor's insolvency. In some of these systems, registration is necessary for a security transfer of title to be effective in general or at least as against third parties.

64. With respect to the assignment of receivables, which is in wide use, a trend is developing in subjecting it to the same provisions whether it involves an outright transfer, an outright transfer for security purposes or a security transfer. This trend is reflected in the United Nations Assignment Convention (see art. 2). However, legal systems differ as to the requirements for an effective assignment. Some legal systems require a writing or notification of the account debtor. Other legal systems require a writing for effectiveness as between the assignor and the assignee and registration for effectiveness as against third parties. Legal systems also differ with respect to the effectiveness of assignments of future receivables and receivables not specifically identified, as well as with respect to the effectiveness of assignments made despite anti-assignment clauses in the contracts from which the assigned receivables arise. The United Nations Assignment Convention validates all those assignments (see arts. 8-10).

(c) Contractual arrangements with a security function

65. Sale and resale, sale and lease-back, hire-purchase and financial leasing transactions often perform security functions. In some legal systems, they are treated as security devices, while in other legal systems they are treated as contractual arrangements creating personal rights. In those legal systems that treat them as non-security devices, the requirements for their creation and effects differ widely.

B. Summary and recommendations

66. It should be possible to secure all types of obligations, including future obligations and a fluctuating amount of obligations. It should also be possible to provide security in all types of asset, including fixtures, and accessions, as well as in assets which the debtor may not own or have the power to dispose of, or which do not exist, at the time of creation of the security right and proceeds of encumbered assets. Any exceptions to these rules should be limited and described clearly in secured transactions legislation.

67. A security agreement creating a non-possessory security right should be in written form. The writing should include a data message and clearly indicate the grantor's intention to grant a security right. It should identify the parties and reasonably describe the secured obligation and the encumbered assets (but should not require a specific description of each encumbered asset). No writing should be required for possessory security rights. Where no formalities are required, the secured creditor should have the burden of proving both the terms of the security agreement and the date of creation of the security.

68. An agreement between the secured creditor and the grantor and transfer of possession of the encumbered asset to the secured creditor or to an agreed third party is necessary for the creation of a possessory security right.

69. An agreement should be sufficient for the creation of a non-possessory security right as between the grantor and the secured creditor. An additional act may be required for the security right to become effective as against third parties.

[*Note to the Working Group: The Working Group may wish to consider recommendations with regard to title-based security.*]