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Draft legislative guide on secured transactions

Report of the Secretary-General

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A. General remarks

1. Introduction

1. Secured transactions regimes typically require a secured creditor to take some additional step before its security right in the encumbered assets takes effect against third parties. The purpose of this additional requirement is twofold. First, it serves to protect third parties dealing with the movable assets of the grantor against the risk that those assets may be encumbered by a security right. Second, it provides a temporal event for ordering priority among secured creditors and between a secured creditor and other competing claimants.

2. This chapter focuses on the five most widely accepted methods for ensuring that a security right acquires proprietary effect against third persons. The first is available only in respect of specific tangibles and involves removing possession of the encumbered assets from the grantor. The second is an extension of the idea of dispossession and involves giving the secured creditor control over the value of intangible obligations owed to the grantor by a third party. The third method is available only if the encumbered assets are specific items of movable property for which the enacting State has established a title registry for recording title and encumbrances against title. The fourth method requires entry of a notation of the security right on a title certificate. Again, this method is available only if the encumbered assets are specific items of tangible movable property for which, under other law of the enacting State, title is evidenced by a title certificate.

3. The fifth and most comprehensive method involves filing a simple notice of the security right in a general security rights registry. Notices are indexed by reference to the identity of the grantor, not the specific asset. This means that a single notice can be used to give third party effect to a security right granted in any item or kind of tangible or intangible movable, whether presently owned or after acquired. The filing of a notice does not constitute positive evidence of the existence of the grantor's title to the encumbered assets or even of the existence of the security right. However, registration is a precondition to the effectiveness of any security right that may have been granted against third parties. In the absence of a registered notice, third parties are not bound.

4. The filing of a notice is not merely a pre-condition to the third party effectiveness of a non-possessory security right. Filing also contributes to positive priority ordering. Most obviously, registration establishes an objectively verifiable temporal event for ordering priorities among secured creditors and between a secured creditor and competing claimants.

5. Priority is the topic of a separate chapter in this Guide (see A/CN.9/WG.VI/WP.14/Add.1). However, the link between registration and priority is a continuing theme in this chapter, and the two chapters should be read in conjunction with each other.

2. Dispossession

(a) General considerations

6. Although removing the encumbered assets from the possession of the grantor does not positively evidence the existence of a security right, it does minimize the risk that creditors and other parties will be misled by the grantor's apparent ownership. For this reason, it has traditionally been accepted as sufficient not just to constitute a security right, but also to make the security right effective against third parties (see A/CN.9/WG.VI/WP.11/Add.2, para. 57).

(b) Possession of the encumbered assets by a third party

7. Dispossession of the grantor need not involve direct possession by the secured creditor. Possession by a third party, such as an agent or representative, of the secured creditor is sufficient provided an objective bystander would reasonably conclude that the encumbered assets are not in the possession or control of the grantor.

8. Dispossession through a third party does not always require physical removal of the encumbered assets from the grantor's premises. In field warehousing arrangements, the third party assumes control of the grantor's inventory and other encumbered assets through a representative located on the grantor's premises. Third parties are protected by virtue of the fact that the grantor's ability to deal with the encumbered assets requires the consent and cooperation of the secured creditor acting through a third party (see A/CN.9/WG.VI/WP.9/Add.1, para.7).

9. If the encumbered assets are covered by a negotiable document of title, for example, a bill of lading or a warehouse receipt, the carrier or warehouse keeper is obligated to deliver the underlying assets to the person currently in possession of the document. Delivery of a properly endorsed negotiable document of title therefore offers an alternative means of removing possession of the underlying assets from the grantor.

3. Transfer of control over intangible obligations to the secured creditor

(a) Trade receivables and other monetary claims

10. In legal systems that accept the negotiability of security certificates (for stocks or bonds), delivery of the certificate with any necessary endorsement transfers the benefit of the obligations owed by the issuer to the secured creditor. Delivery of the certificate is therefore the functional equivalent of dispossession through an agent of the secured creditor. The same result can be achieved for certificated securities held with a clearing agency by entering the name of the secured creditor in the books of the clearing agency, and for uncertificated securities, by registering the name of the secured creditor in the books of the issuer. In the case of indirectly held investment property, control over the obligations owed by the broker or other intermediary can be transferred either by putting the investment account in the name of the secured creditor, or obtaining the agreement of the intermediary to respond to the directions of the secured creditor.

11. This Guide does not address issues relating to security rights in investment property. Nonetheless, the idea of control as a method for achieving third party effectiveness of a security right can be applied to other types of intangible

obligations owed by a third person to the grantor. For example, the grant of security in an ordinary trade receivable or other monetary claim generally entitles a secured creditor, in the case of default by the grantor, to demand payment from the person owing the obligation. A demand for payment thus transfers practical control over the monetary claim to the secured creditor.

12. On the other hand, a secured creditor generally will not demand direct payment of monetary obligations owed to the grantor until there is a default on the part of the grantor. Even when the monetary claims are sold outright, the assignee will frequently wish to leave collection in the hands of the assignor. In light of these practicalities, it may be preferable to treat a demand for payment simply as a collection or enforcement technique and not a method for achieving the third party effectiveness of a security right. This is particularly appropriate where the option of filing a notice in a security rights registry is available to both secured creditors and assignees. Registration offers a more efficient means of evaluating priority risk at the outset of the transaction particularly where the security right covers all of the grantor's present and after-acquired monetary intangibles.

(b) Deposit accounts

13. Where the encumbered assets take the form of a deposit account held by the grantor with a financial institution or other deposit-taking institution, transfer of control to the secured party can be achieved by putting the name of the secured creditor on the account. Alternatively, the parties could enter into a control agreement under which the institution undertakes to respond exclusively to the directions of the secured creditor in dealing with the account. To protect the information needs of the grantor's creditors and other interested third parties, it may be necessary to require the deposit-taking institution to respond to a demand for confirmation as to whether such a control agreement has been entered into.

14. The deposit-taking institution may itself be owed money by the grantor. Rather than going through the exercise of entering into a control agreement, it may be simpler to treat a deposit-taking institution that takes security in a customer's deposit accounts as having automatic control by operation of applicable law. Once again, however, to satisfy the information needs of third parties, it may be necessary to require the institution to verify to legitimately interested third persons whether it has entered into a control agreement covering the deposit account.

4. Title-based modes of publicity

(a) Title registry systems

15. Dispossession and equivalent control techniques are available only if the grantor is prepared to give up ongoing use and enjoyment of the encumbered assets. They are not feasible if the grantor needs to retain control of the encumbered assets in order to produce its services or products or otherwise generate profit.

16. For limited categories of high value assets, a State may have adopted a specialized title registry similar to a land title registry. Where a title registry exists, it offers a convenient venue for registering non-possessory security rights in such high-value assets so as to make them effective against third parties. Ships, aircraft, motor homes, and intellectual property rights (notably patents and trade marks) are the most commonly encountered examples of assets for which title registries exist.

(b) Title certificate systems

17. Some jurisdictions have established title certificate systems to evidence the acquisition and transfer of title in specific items of movable property (for example, motor vehicles). Entry of a notation of a security right granted by the owner named on the certificate is usually sufficient to make it effective against third parties.

5. Registration of a notice of security in a general security rights registry

(a) General considerations

18. A fifth mode of publicity involves filing a notice of the security right in a public registry established for this purpose. Unlike the modes already considered, notice filing offers a universal means of achieving effectiveness against third parties, regardless of the nature of the encumbered assets. As such, it contributes to efficient priority ordering, enabling a priority competition among secured creditors and between a secured creditor and other third parties to be settled by reference to the timing of registration.

19. A notice-based security rights registry is very different from a title registry and from a secured transactions registry based on document filing. A title registry functions as a source of positive information about the current state of title to specific assets. To protect the integrity of the title record, the registrant is generally required to file the actual title transfer documents or tender them for scrutiny by the registrar. Similarly in a document filing secured transactions registry, the actual security documentation is submitted to and checked by a registrar who then issues a registration certificate that constitutes at least presumptive evidence of the existence of the security right.

20. A notice-filing registry on the other hand, operates on a theory of negative publicity. Registration of a notice does not provide positive proof of the existence of the security right but rather provides a warning to third parties about the possible existence of a security right that allows third parties to take further steps to protect their own interests (see para. 39). Since filing constitutes a precondition to the effectiveness of a security right against third parties, it is the absence of registrations on which third parties rely in concluding that they will take the encumbered assets free of any prior security rights. There is therefore no need to require secured creditors to register the security agreement or otherwise prove its existence. From the grantor's perspective, protection from unauthorized registrations can be achieved by requiring the named grantor to be informed of any registration and by establishing a summary administrative procedure to facilitate the removal of unauthorized registrations.

21. Notice filing greatly simplifies the registration process and minimizes the administrative and archival burden on a registry system. It also enhances flexibility during the duration of the financing. So long as the description of the encumbered assets set out in the registered notice does not change, a single notice is sufficient to give third party effect to all security agreements entered into between the same parties (see A/CN.9/WG.VI/WP.14/Add.1, para.19-22).

22. The concept of a notice-based registry has attracted considerable international support. Model systems have been developed by the European Bank for Reconstruction and Development (General Principles of A Modern Secured

Transactions Law, 1997; Model Law on Secured Transactions, 1994), the Organization of American States (Model Inter-American Law on Secured Transactions, 2002), and the Asian Development Bank (Law and Policy Reform at the Asian Development Bank: A Guide to Movables Registries, December 2002). The Convention on International Interests in Mobile Equipment, 2001 and the related Aircraft Protocol provide for an international priority regime based on a filing system for interests in aircraft arising under security agreements, leases and title retention sales agreements. The United Nations Assignment Convention also offers notice filing as the basis for one of the optional priority systems set forth in its annex.

(b) Asset v. grantor indexing

23. A notice of security must be indexed according to established criteria to permit its efficient retrieval. Notices in a security rights registry are generally indexed by reference to the identity of the grantor. Asset-based indexing is feasible only for assets that have a serial number or other unique identifier. Even then, the value of individual items within a generic category (e.g. all tangible movables) may be too modest to justify the cost involved in tracking registrations on an item-by-item basis. In addition, asset-based indexing does not accommodate the registration of a notice covering security in after-acquired assets, or circulating assets, for example inventory and receivables.

24. Grantor-based indexing greatly simplifies the registration process. Secured creditors can give third party effect to a security right in all of a grantor's present and after-acquired movable property, or in generic categories, through a single one-time registration. They need not worry about updating the record every time the grantor acquires a new item within the generic category set out in the registered notice.

25. Grantor-based indexing has one drawback. If the encumbered assets become the object of unauthorized successive transfers, prospective secured creditors and buyers cannot protect themselves by conducting a search according to the name of the immediate apparent owner. Because the system is grantor-indexed, the search will not disclose a security right granted by a predecessor in title.

26. A partial solution to this problem would be to require asset-based indexing for particularly high-value assets for which reliable numerical identifiers exist, for example, motor vehicles, boats, mobile homes, trailers, aircraft, and so forth. Although specific asset identification limits the ability to use a single notice to give third party effect to security in after-acquired assets, it is usually necessary only for capital assets used in the grantor's business (and consumer assets used for personal purposes to the extent these are covered by the secured transactions law of the enacting State). In cases where the assets are held by the grantor as inventory, this problem is addressed since a buyer in the ordinary course of business will, in any event, acquire the assets free of the security right. (see A/CN.9/WG.VI/WP.14/Add.1).

27. An alternative or complementary approach would be to require secured creditors who find out about a transfer or sale by the grantor to add the transferee or buyer as an additional grantor on the registered notice in order to preserve priority over subsequent competing claimants. Alternatively, protection might be extended

to all subsequent buyers, or even all subsequent third parties, even where the secured creditor has no knowledge of the debtor's unauthorized disposition (see also A/CN.9/WG.VI/WP.14/Add.1, para. 64-72).

(c) Content of registered notice

i. Identification of grantor

28. Since grantor identity is the usual means by which notices of security are retrieved, registrants and searchers require guidance on the correct mode of setting out the identity of the grantor on the registered notice. The grantor's name and address is the most common criterion.

29. For corporate grantors and other legal persons, the correct name can usually be verified by consulting the public record of corporate and commercial entities maintained by most States. If the information in this record and in the security rights registry is stored in electronic form, it may be possible to provide a common gateway to both databases to simplify the verification process.

30. For individual grantors, verification of the correct name is a little more challenging. There may be inconsistencies between the grantor's popular and formal birth names, or between the names that appear on different identity documents. Name changes may have occurred since birth as a consequence of deliberate choice or a change in marital status. The provision of explicit legislative guidance to deal with these various contingencies ensures that registrants and searchers are operating according to the same criteria. For example, the regulations or administrative rules governing the operation of the registry might specify a hierarchy of official sources, beginning with the name that appears on the grantor's birth certificate, and then referencing other sources (for example, a passport or driver's licence) in situations where there is unavailable or is inaccessible.

31. If more than one grantor shares the same name, the provision of the grantor's address will often resolve the identity issue for searchers. In States where many individuals share the same name, it may be useful to require supplementary information, such as the grantor's birth date. If a State has adopted a numerical identifier for its citizens, this can also be used, subject to privacy concerns, and subject to prescribing an alternative identifier for grantors who are non-nationals.

32. The impact of an error in the grantor's name on the legal validity of a notice depends on the organizational logic of the particular registry system. For instance, some electronic records are programmed to disclose only exact matches between the name entered by the searcher and the names in the database. In such a system, any entry error will nullify the registration because it will render the notice irretrievable by searchers using the correct name of the grantor. In other systems, it may be possible to also retrieve close matches in which event the registered name may well turn up on a search using the correct identifier notwithstanding the entry error. Whether the error nonetheless invalidates the registration depends on the particular case. A useful flexible test would be to treat the error as fatal only if the information disclosed on the notice would mislead a reasonable searcher.

ii. Identification of secured creditor

33. Entry of the name and address of the secured creditor or the secured creditor's representative on the registered notice enables third parties to contact the secured creditor, if necessary. It also provides presumptive evidence that the secured creditor who later claims a priority based on the notice is in fact the person entitled to do so. The rules used for determining the correct name of a grantor can also be applied to secured creditors. However, the name of the secured creditor is not an indexing criterion. Consequently, registration errors in relation to a secured creditor do not pose the same risk of misleading third party searchers and would not lead to nullification of the notice.

iii. Description of encumbered assets

34. A description of the encumbered assets must also be included on the notice. The absence of a description would hamper the ability of a grantor to sell or grant security in assets that remain unencumbered since prospective buyers and secured creditors would demand some form of protection (for example, a release from the secured creditor) before entering into transactions involving any of the grantor's assets. The absence of a description would also diminish the value of the notice for insolvency administrators and judgement creditors.

35. Although a description of the encumbered assets is normally required, there is no need for a specific item-by-item description. The information needs of searchers are sufficiently served by a generic description (e.g. all tangible assets, all receivables) or even a super-generic description (e.g. all present and after-acquired movables). Indeed, generic description is necessary to ensure the efficient registration of a security right granted in after-acquired assets, and in revolving categories of assets, such as inventory or monetary claims.

36. A more difficult question is whether the notice need only indicate the generic nature of the encumbered assets (e.g. tangible movables), even if the security right is in fact limited to a specific item (e.g. a single automobile), or whether the description should have to conform to the actual range of assets covered by the background security documentation.

37. The first approach simplifies the registration process and reduces the risk of descriptive error. It also permits the parties to amend their security agreement to add new assets within the same generic category without the need to make a further registration. On the other hand, this approach may complicate grantor access to financing against the unencumbered portion of the described assets. Since priority dates from the time of registration, subsequent buyers and secured creditors will require an explicit waiver or discharge to protect them against the risk that the grantor may later expand the actual scope of the assets covered by the initial security agreement.

iv. Maximum value of secured obligation

38. A further question is whether the notice must disclose the monetary value of the secured obligation. It is not desirable to require the actual or intended value to be set out because this would interfere with the flexibility of credit transactions such as revolving credit transactions. However, secured creditors could be required to specify the maximum amount to be secured by the security right. This approach

would facilitate the grantor's ability to use the residual value of assets subject to a broad security right to secure further financing from other secured creditors. On the other hand, the first secured creditor to take a general security right over the grantor's assets is typically the cheapest and most available source of credit. In addition, the value of imposing such a requirement would be lost if inflated estimates were routinely filed.

(d) Access to more detailed information

39. Prospective buyers and secured creditors can generally deal with the priority risk presented by a registered notice without having to investigate further. They can refuse to deal further with the grantor, obtain a release or subordination agreement from the registered secured creditor or require the grantor to bring about a discharge of the registration (in cases where the registration does not represent an extant security right or where a new secured creditor is prepared to advance sufficient funds to pay out the prior registered secured creditor).

40. Third parties in the position of unsecured creditors and insolvency representatives, along with co-owners of the encumbered assets, are in a somewhat different position. They already have an existing or potential claim against the encumbered assets. However, the value of their claim can be determined only if they know the value of the outstanding obligation owing to the secured creditor since that claim has priority of payment. Since the grantor of the security right may not be a reliable or cooperative source of this information, it may be desirable to impose a legal obligation on secured creditors to directly respond to a demand by interested third parties for further information on the current state of the financing relationship within reasonable time.

(e) Duration of registration

41. The duration of secured financing relationships can vary considerably. The necessary flexibility can be accommodated in one of two ways. The first is to allow registrants to select the desired term of the registration with a right to file renewals. The second is to set a universal fixed term (e.g. five years), also accompanied by a right to file renewals.

42. In medium- and long-term financings, the first approach lessens the risk for secured creditors of a loss of priority for failure to renew in time. In short-term arrangements, the second approach reduces the risk for grantors that secured creditors will register for an inflated term out of an excess of caution.

43. Regardless of which approach is adopted, it is necessary from the perspective of the grantor to ensure that notices are expunged from the record within a reasonable period after the secured obligation is satisfied. Possible solutions include the imposition of a financial penalty on secured creditors who fail to register a timely discharge combined with the establishment of a summary administrative procedure for compelling discharge if the secured creditor fails to respond to a justified demand to do so by the grantor. As an added incentive to timely action, it may be desirable to give secured creditors the right to register a discharge free of charge.

(f) Administrative issues

i. Technological considerations

44. If the registry records are organized on a regional or district basis, complex rules are needed to determine the appropriate registration venue and to deal with the consequences of a relocation of the assets or the grantor. On the other hand, a single national registry can create inequalities of access. Computerization of the registry data base resolves both problems by enabling all registrations to be entered into a single central record while also allowing for remote registration and searching.

45. An electronic database can support a fully electronic registration system, in which users have direct computer access to the electronic database for both registration and searching. This significantly reduces the costs of operation and maintenance of the system. It also enhances the efficiency of the registration process by putting direct control over the timing of entry into the hands of the registering party, thereby eliminating any time lags between submission of a notice and the actual entry of the information contained in the notice into the database. Perhaps most importantly, a fully electronic system places all responsibility for accurate data entry on registrants and searchers, thereby minimizing staffing and operational costs.

46. The optimal extent of computerization depends on the level of start-up costs of the registry, computer literacy among the registry client base, the reliability of existing communications infrastructure, and on an assessment of whether expected revenues will be sufficient to recover the initial capital costs of construction within a reasonable period. The overall objective is to make the registration and searching process as simple, transparent and accessible as possible within the context of the particular State.

ii. Liability for system error

47. If the system is exclusively electronic, there is no risk of human error on the part of the registry office at either the registration or searching stages. The responsibility is cast on the registrants and searchers. As for the risk of system breakdown, the consequences can usually be alleviated by prompt notification of clients and by extending any time periods that might have run out during the breakdown period. To the extent input of data and the entry of searches is carried out by registry staff, the risk of human error in transposing and retrieving data is present. However, this can be alleviated by establishing electronic edit checks and ensuring the timely return to the client of a copy of the registration data or search result.

48. Whatever the design of the system, specific rules need to be made regarding the extent of the registry's legal responsibility, if any, for staff or system error. One compromise solution would be to allocate a portion of the registry revenues to a mandatory compensation fund and to impose an upper limit on the amount of compensation for any single incident.

49. Assuming a compensation claim is available, further rules need to be made on who carries the risk of error as between registrants and third party searchers. In resolving this issue, the rules might, for example, provide that an indexing error on the part of registry staff does not prejudice the third party effectiveness of a security

right except as against secured creditors or purchasers who can positively establish that they searched and suffered actual damage as a result of acting to their detriment on the misleading information contained in the record.

iii. Registration fees

50. High registration and search fees designed to raise revenue rather than support the cost of the system are tantamount to a tax, ultimately borne by grantors, on secured transactions. To encourage access to secured credit at a reasonable cost, it is critical for the success of the system to set fees at a nominal level that encourages use of the system, while still enabling the system to recover its capital and operational costs within a reasonable time.

iv. Confidentiality considerations

51. A notice-based registration system enhances the confidentiality of the grantor's and secured creditor's relationship by limiting the level of detail about their affairs that appears on the public record.

52. The topic of confidentiality raises the issue of whether the registry system should be organized to facilitate public searching against the name of the secured creditor as well as the grantor. The quantity and content of notices filed by a particular financial institution or other creditor may have market value as a source of a competitor's customer lists or for companies seeking to market related financial or other products. Although the additional revenues would be attractive, the retrieval and sale of this kind of information is not relevant to the legal mission of the registry and may inhibit use of the system by secured creditors.

(g) Advance registration

53. The establishment of a security rights registry enables competing registered security rights in the same encumbered asset to be resolved according to a general first-to-file rule. The exceptions to this general rule are dealt with in detail in the chapter on priority (see A/CN.9/WG.VI/WP.14/Add.1, paras. 13-17). However, an issue that is relevant at this stage is whether a secured creditor should be permitted to file a notice of security in advance of the actual conclusion of the security agreement (a notion similar to the pre-notation of a mortgage in a land registry).

54. Advance filing enables a secured creditor to establish its ranking against other secured creditors without having to check for further filings before advancing funds. Advance registration also avoids the risk of nullification of the registration in cases where the underlying security agreement happens to have been technically deficient at the point of registration but is later rectified, or where there are factual uncertainties as to the precise time when the security agreement was concluded.

55. From the perspective of the grantor, adequate protection from the risk that no security agreement is ever concluded can be assured through the same measures used in the case of unauthorized registrations (i.e. by requiring that the named grantor be informed of any registration and by establishing a summary administrative procedure to enable the grantor to compel a discharge if the identified secured creditor fails to act within a reasonable time).

(h) Additional rights subject to registration

56. Third persons dealing with tangible movables in the possession of a buyer under a sale of goods in which the seller has retained title to secure payment of the price face the same risk as those dealing with a grantor in possession of encumbered goods. In the absence of a public notice filing system, third persons, including prospective secured creditors, have no objective means of verifying whether the goods are bound by the seller's retention of title.

57. One means of alleviating this risk is to require the seller to file a notice of the retention of title agreement in the security rights registry as a precondition to the right of the seller to set up its title against third parties who subsequently acquire an interest in the goods in the hands of the buyer.

58. Other categories of non-possessory transactions for which registration of a notice might be imposed as a condition of third party effectiveness are:

- A lease of tangible assets of significant duration (e.g. one year);
- An outright assignment of monetary claims;
- A consignment for sale of tangible assets.

59. Whether the priority rules that apply to registered security rights should also apply to these transactions is a more complex question. The first-to-file rule has obvious utility where an assignment of claims comes into competition with a security right granted in the same claims. However, in the case of a lease, a consignment, or a retention of title sale, temporal priority ordering has to be qualified in order to preserve the lessor's, the seller's or the consignor's title as against prior registered security rights, perhaps subject to the requirement that registration be effected within a set time period after the transaction. These details are taken up in the chapter on priority (see A/CN.9/WG.VI/WP.14/Add.1, paras. 47-55 and 77-79).

60. The extension of the registration requirements for security rights to commercial transactions that are not denominated as security transactions but perform security functions is reflected at the international level in two conventions. The first is the Convention on International Interests in Mobile Equipment, which extends the international registry contemplated by the Convention beyond charges to also include retention of title agreements in favour of sellers and aircraft leasing arrangements. The second is the United Nations Assignment Convention under which the choice of law rules governing issues of third party effectiveness and priority apply to both the outright assignment and the grant of security in receivables.

61. Some legal systems have expanded the scope of the security rights registry to permit registration of a notice of a monetary judgment indexed according to the identity of the judgment debtor, with registration creating the equivalent of a security right in the movable assets of the judgement debtor in favour of the judgment creditor. This approach can indirectly promote the prompt voluntary and prompt satisfaction of judgement debts since third parties will be reluctant to buy or take security in the encumbered assets until the judgment debtor has paid the judgement and brought about a termination of the registration.

62. If this approach is adopted, it is necessary to ensure that the registered judgement creditor's right does not conflict with insolvency policies requiring equality of treatment among the debtor's unsecured creditors. This can be resolved by a rule entitling the insolvency administrator to claim the monetary benefit of the registered judgment creditor's priority for the benefit of all unsecured creditors (perhaps subject to a special privilege in favour of the registered judgement creditor to compensate for registration expenses and efforts; see also A/CN.9/WG.VI/WP.14/Add.1, paras. 56-61).

(i) Alternative notice venues

63. In lieu of a public registry, some legal systems have endorsed more limited notice venues for a public registry (for instance, entry of a notice in the grantor's own books, or in the books of a notary or court official, or in newspapers in the grantor's locale, or in a government journal). Although some of these notice venues sufficiently address concerns with fraudulent antedating, in comparison to a comprehensive public security rights registry, they lack the permanence and ease of public accessibility needed to adequately protect third parties. Moreover, they do not offer the priority ordering benefits of a first to file rule.

64. Some legal systems allow affixation of a plaque or other form of physical notice to the encumbered asset as a substitute for registration. The reliability of such a mechanism is limited in view of the potential for abuse by the grantor. However, in some markets, the specialized nature of the asset and industry practice may make this form of symbolic possession acceptable (e.g. branding of cattle).

6. Alternatives to a general security rights registry for non-possessory security rights

(a) General considerations

65. In jurisdictions that choose not to establish a general security rights registry, there are three possible responses to determining the legal efficacy of a non-possessory security right against third parties. The first is to treat all non-possessory security rights as ineffective save those for which the State already has established a title registry or title certificate system through which public notice of the security right can be given. In view of the modern demand for financing against the inventory, receivables and other commercial assets of a business, this is not a feasible alternative. The second is to treat non-possessory security rights as effective both between the parties and against competing claimants as soon as they are created. The third is really a variant of the second and involves giving special protection to specified classes of third parties, for example those who rely to their detriment on the grantor's apparent ownership.

66. In order to adequately compare these latter two alternatives with a security rights registry system, it necessary to look at the issue in relation to each of the principal categories of competing claimants.

(b) Competing secured creditors

67. In a system in which non-possessory security rights take effect against each other according to the order of their creation rather than the order of registration, the cost and risk of registration is eliminated and there is no need to invest in the

establishment of a general security rights registry. On the other hand, a public registry system enables prospective secured creditors to more accurately assess their priority risk against each other. In its absence, they must rely on the assurances of the grantor that the assets are not already encumbered, and their own inquiries and perceptions. This additional investigatory burden for secured creditors may impede access to credit by prospective borrowers without an established credit record, and restrict credit market competition by shutting out smaller credit-providers who do not have access to a credit information network.

(c) Buyers of encumbered assets

68. By virtue of the proprietary character of security rights, a secured creditor is presumptively entitled to follow the assets into the hands of a third-party buyer who acquires title under an unauthorized sale by the grantor (droit de suite). In the absence of a registry system, preservation of the secured creditor's droit de suite must be balanced against the need to protect the certainty of sales of movables. This may require a rule protecting the title acquired by buyers who take without actual or presumptive knowledge of an unpublicized non-possessory security right. A registry system dispenses with the need to choose between these two values, namely, respect for the (droit de suite) on the one hand and certainty of sale of movables on the other hand. The security right can fairly take effect against third parties on registration since buyers can protect themselves in advance of the purchase by conducting a search of the registry (subject to the caveat that buyers in the ordinary course of business and possibly buyers in good faith or unsophisticated buyers take the assets free of even a registered security right in the interests of commercial convenience; see A/CN.9/WG.VI/WP.14/Add.1, paras. 64-72).

(d) The grantor's insolvency representative and judgment creditors

69. In legal systems that have not established a general registry system, a non-possessory security right is normally treated as effective against the grantor's insolvency representative and judgement creditors, provided it is granted before insolvency or enforcement proceedings are initiated (or before any pre-insolvency suspect period begins to run). This is sometimes justified on the basis that unsecured creditors do not rely on the grantor's unencumbered ownership since the very act of extending credit without taking security implies an acceptance of the risk of subordination to the proprietary rights of subsequent secured creditors.

70. However, making registration a pre-condition to the effectiveness of a non-possessory security right against the insolvency representative and unsecured creditors offers a number of advantages. First, it offers a certain date for priority ordering thereby reducing the risk of fraudulent antedating of security instruments. Second, it reduces the cost of insolvency proceedings by giving the insolvency representative an efficient means of ascertaining which security rights are presumptively effective (see A/CN.9/WG.VI/WP.9/Add.6, para. 2). Outside of formal insolvency, registration likewise enables judgement creditors to determine in advance of initiating costly execution action whether the debtor's assets are already encumbered by security.

7. Third party effectiveness of security rights in proceeds

71. Where a secured transactions law gives secured parties an automatic statutory security right in the identifiable proceeds of the originally encumbered assets, some regimes provide that the security right is automatically effective against third parties as soon as the proceeds arise. Other regimes require the secured creditor to take independent action to make the security right in the proceeds effective against third parties. To require independent action may undermine the rationale behind giving the secured creditor an automatic proceeds security right since the proceeds will often arise as a result of an unauthorized disposition of the original encumbered assets by the grantor (which the secured creditor typically will not become aware of until some time after the fact). On the other hand, to give automatic effect to the security right in proceeds contradicts the purposes of requiring a secured creditor in relation to the original encumbered assets to take possession or register as the case may be in order for its security right to be effective against third parties (see also A/CN.9/WG.VI/WP.14/Add.1, para. 26-35).

72. In resolving these competing policies, it is useful to draw a distinction among different categories of proceeds. First, suppose that a notice of the security right in the original encumbered assets was registered in a general security rights registry and the proceeds are of a kind that fall within the description set out in the registered notice. For example, the registered notice covers all present and after-acquired tangibles of the grantor and the original encumbered asset, a piece of equipment, is exchanged for another piece of equipment of the same kind. In this example, the security right should take automatic effect since third parties are already adequately protected by the existing registered notice which, in effect, covers the proceeds as originally encumbered assets in the form of after-acquired equipment.

73. If on the other hand, the proceeds take the form of money, negotiable instruments or negotiable documents of title, it would be relatively safe to allow for the security right in the proceeds to take automatic effect against third parties since transferees will normally take the assets free of any security right in any event owing to the negotiable character of the proceeds.

74. A more difficult case is one where the proceeds take the form of receivables arising from the disposition of the original encumbered assets, for example, inventory. In order to facilitate inventory financing, it may be desirable to give automatic third party effect to the proceeds security right, either on the theory that receivables are impliedly part of the originally encumbered assets, or on a theory of real subrogation, namely, that the receivables have simply replaced the originally encumbered assets so there is no unfairness to creditors in allowing the secured creditor to shift its claim to the receivables.

75. Apart from these three exceptions, the policies underlying the third party effectiveness rules apply in principle to a security right in proceeds (i.e. a secured creditor has to separately register its right in proceeds). However, it may be fair to give the secured creditor a limited time period after the proceeds arise to take the necessary steps. For example, the law might provide that a proceeds security right takes effect against third parties as soon as the proceeds arise provided the secured creditor, within, e.g., fifteen days, takes possession of the proceeds, or registers a

notice, or does some other act that would be sufficient to give third party effect to a security right in encumbered assets of the same type as the proceeds.

B. Recommendations

[*Note to the Working Group: As documents A/CN.9/WG.VI/WP.13 and Add.1 include a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations on Effectiveness against third parties are not reproduced here. Once the recommendations are finalized, the Working Group may wish to consider whether they should be reproduced at the end of each chapter or in an appendix at the end of the guide or in both place*s.]