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Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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VI. Priority

A. General remarks

1. The concept of priority and its importance

1. The term "security right", as used in this Guide, refers to a right in property granted to a creditor to secure the payment or other performance of an obligation (i.e. an *in rem* right). The term "priority", on the other hand, refers to the extent to which the creditor may derive the economic benefit of that right in preference to other parties claiming an interest in the same property (see A/CN.9/WG.VI/WP.11/Add.1, para. 17 (q), definition of "priority"). As discussed below, these competing claimants may include, among others, unsecured creditors of the grantor, other secured creditors, buyers, sellers or lessees of the property, holders of non-consensual security rights in the property (such as security rights arising from judgements or created by statute) and the insolvency representative in the grantor's insolvency proceeding. Priority rules determine the ranking of security rights and other rights in encumbered assets and the economic result of such ranking. In some cases, the application of priority rules will lead to a person taking the asset free of competing claims. Both types of cases are covered by this chapter.

2. The concept of priority is at the core of every successful legal regime governing security rights and it is therefore widely recognized that effective priority rules are necessary to promote the availability of low-cost secured credit. There are two primary reasons for this. First, to the extent that priority rules are clear and lead to predictable outcomes, prospective secured creditors are able to determine, in an efficient manner and with a high degree of certainty prior to extending credit, the priority that their security rights will have relative to the rights of competing claimants. This in turn reduces the risks to such prospective creditors and thereby has a positive impact on the availability and cost of secured credit. Second, by providing a mechanism for the ranking of claims, priority rules make it possible for grantors to create more than one security right in their assets, thus utilizing the full value of their assets to obtain more credit (which is one of the key objectives of any effective and efficient secured transactions regime; see A/CN.9/WG.VI/WP.11/Add.1, para. 31).

3. With respect to the first reason noted in paragraph 2 above, a creditor will normally extend credit on the basis of the value of specific property only if the creditor is able to determine, with a high degree of certainty prior to the time it extends credit, the extent to which other claims will rank ahead of its security right in the property. The most critical issue for the creditor in this analysis is what its priority will be in the event of the enforcement of the security right or the grantor's insolvency, especially where the encumbered asset is expected to be the creditor's primary or only source of repayment. To the extent that the creditor has uncertainty with respect to its priority at the time it is evaluating whether to extend credit, the creditor will place less reliance on the encumbered asset. This uncertainty may cause the creditor to increase the cost of the credit to reflect the diminished value of the encumbered asset to the creditor, and may even cause the creditor to refuse to extend credit altogether.

4. To minimize this uncertainty, it is important that secured transactions laws include clear priority rules that lead to predictable outcomes. The existence of such priority rules, together with efficient mechanisms for ascertaining and establishing priority at the time credit is advanced, may be as important to creditors as the particulars of the rules themselves. It often will be acceptable to a creditor that certain competing claimants have a higher priority, as long as the creditor can determine that it will ultimately be able to realize a sufficient value from the encumbered assets to repay its claim in the event of non-payment by the grantor. For example, a lender considering a loan to a grantor secured by an all-asset security may be willing to make the loan even if the inventory is subject to various security rights (such as a security right in favour of a warehouseman who stores inventory for the grantor), as long as the lender can ascertain with reasonable certainty, the nature and amount of such claims.

5. With respect to the second reason noted in paragraph 2 above, many banks and other financial institutions are willing to extend credit based upon security rights that do not have a first-priority ranking but are subordinate to one or more prior security rights, so long as they perceive there to be sufficient value in the grantor's assets to support their security rights and can clearly establish the second-priority position of their security rights. For example, in jurisdictions that recognize an all-asset security (see A/CN.9/WG.VI/WP.11/Add.1, para. 25), Lender B may be willing to extend credit to a grantor whose assets are already subject to an all-asset security in favour of Lender A, so long as Lender B believes that the value of the grantor's assets sufficiently exceeds the amount of the loan secured by the existing all-asset security to support the additional extension of credit by Lender B. This result is much more likely to occur in a jurisdiction that has clear priority rules that enable creditors to assess their priority with a high degree of certainty. By facilitating the granting of multiple security rights in the same assets, priority rules enable a grantor to maximize the extent to which it can use its assets to obtain credit.

6. It is important to note that no matter what priority rule is in effect in any jurisdiction, it will only have relevance to the extent that the applicable conflict-of-laws rules provide that such priority rule governs. This issue is discussed in chapter X (see A/CN.9/WG.VI/WP.14/Add.4, paras. 10-18).

2. Approaches to determining priority

7. There are various possible approaches to determining priority. It is important to note that more than one of these approaches may effectively coexist in the same legal system insofar as they may apply to different types of priority conflicts.

(a) First-to-file priority rule

8. As discussed above (see paras. 2-5), in order to effectively promote the availability of low-cost credit, it is important to have priority rules that permit creditors to determine their priority with the highest degree of certainty at the time they extend credit, and that enable grantors to use the full value of their assets to obtain credit. As discussed in chapter V (see A/CN.9/WG.VI/WP. 14, paras. 19-23), one of the most effective ways to provide for such certainty, at least in the case of non-possessory security rights, is to base priority on the use of a public registration system.

9. In many jurisdictions in which there is a reliable registration system, priority is determined by the order of registration, with priority being accorded to the earliest registration (often referred to as the "first-to-file priority rule"). In some jurisdictions, this rule applies even if one or more of the requirements for the creation of a security right have not been satisfied at the time of the registration, which avoids the need for a creditor to search the registration system again after all remaining requirements for the creation of its security rights have been satisfied. This rule provides the creditor with certainty that, once it files a notice of its security right, no other registration will have priority over its security right. Other existing or potential creditors are also protected because the registration will put them on notice of pre-existing security rights, or potential security rights, and they can then take steps to protect themselves (such as by requiring personal guarantees or junior security rights in the same property or senior security rights in other property). Notwithstanding the foregoing, limited exceptions to the first-to-file priority rule may be appropriate, such as in the case of purchase-money security rights (discussed in section 5 (c) below) or statutory (e.g. preferential) creditors (discussed in section 5 (j) below).

10. Some jurisdictions provide that, as long as registration occurs within a certain "grace period" after the date on which the security right is created, priority will be based on the date of creation rather than on the date of registration. Thus, a security right that is created first, but registered second, may still have priority over a security right that is created second but registered first, as long as the first security right is registered within the applicable grace period. As a result, until the grace period expires, the registration date is not a reliable measure of a creditor's priority ranking, and there is significant uncertainty that does not exist in legal systems in which no such grace periods exist. In order to avoid undermining the certainty achieved by the first-to-file rule, some jurisdictions restrict the use of grace periods to rare circumstances, such as (i) purchase-money security rights in equipment (see para. 53 below), (ii) circumstances in which registration before, or concurrently with creation is not logistically possible, or (iii) where the time difference between creation and registration cannot be minimized through the use of electronic registration or other registration techniques.

11. In many legal systems, the ordering of priority according to the timing of registration applies even if the creditor acquired its security right with actual knowledge of an existing unregistered security right. This rule is generally predicated on the theory that qualifications based on actual knowledge require a fact-specific investigation of a subjective state of mind, which is particularly difficult in the context of corporations and other artificial persons. As a result, priority rules that are dependent on actual knowledge provide opportunities to subject registrations to challenge and complicate dispute resolution, thereby diminishing certainty as to the priority status of secured creditors and hence reducing the efficiency and effectiveness of the system. As in the case of grace periods, there is no unfairness to secured creditors in this approach because they can always protect themselves by making a timely registration.

12. Many jurisdictions have adopted an exception to the first-to-file priority rule where the registration system consists of a title registry system or a title certificate system. A security right registered in one of these systems is often given priority over a notice previously registered in a general security rights registry in order to

ensure that purchasers of assets that are registered in these systems can have full confidence in the records of the system in assessing the quality of the title they are acquiring.

(b) Priority based on possession or control

13. As discussed in chapters III and V (see A/CN.9/WG.VI/WP.9/Add.1, paras. 5-14, and A/CN.9/WG.VI/WP.14, paras. 7-9), possessory security rights traditionally have been an important component of the secured transactions laws of most jurisdictions. In recognition of this, even in certain jurisdictions that have a first-to-file priority rule, priority may also be established based on the date that the creditor obtained possession or control of the encumbered asset, without any requirement of a registration (see A/CN.9/WG.VI/WP.11/Add.1, para.17 (bb), definition of "control"). In these systems, priority is often afforded to the creditor that first either registered a notice of its security right in the registration system or obtained a security right by possession or control. However, because possession or control often is not a public act, the holder of security rights made effective against third parties by possession or control will, under many legal regimes, have the burden of establishing precisely when it obtained possession or control.

14. In the case of certain types of encumbered assets, (i.e. negotiable instruments such as certificated investment securities, or negotiable documents of title such as bills of lading and warehouse receipts), creditors often require possession or control to prevent prohibited dispositions by the grantor. For these types of assets, the laws of many jurisdictions provide that priority of a security right therein may be established either by possession, control or registration. However, a security right that becomes effective against third parties by possession or control is generally accorded priority over a security right made effective against third parties only by registration, even if the registration occurs first. This result is consistent with the expectations of the parties in the case of negotiable instruments and negotiable documents, because rights in such assets are traditionally transferred by possession.

15. In legal systems where priority of a security right may be established by more than one method (e.g. by registration, possession or control), a question arises as to whether a secured creditor who initially established priority by one method should be permitted to change to another method without losing its original priority ranking with respect to the encumbered asset. In principle, there is nothing objectionable about permitting a creditor to retain its priority in this circumstance, provided there is no gap in the continuity of registration, possession or control, so that the security right is subject to one method or another at all times. Thus, if the law provides that a security right may become effective against third parties by registration or possession, and a security right in an asset first becomes effective by registration and the secured creditor subsequently obtains possession of the asset while the registration is still effective, the security right remains effective as against third parties and priority relates back to the date of registration. If, on the other hand, the secured creditor obtains possession of the asset after the registration has lapsed through the passage of time or otherwise, the priority of the security right should be determined as of the date on which the secured creditor obtained possession.

(c) Alternative priority rules

16. In legal systems that do not have a reliable registration system or any registration system at all, both effectiveness of a security right against third parties and priority are often based on the date that the security right is created. In those jurisdictions, although non-possessory security rights may be permitted (often in the form of retention of title or transfers of title for security), creditors typically confirm the existence or non-existence of competing claims through representations by the grantor or information available in the market. In such jurisdictions, because there is no system to determine the ranking of creditors with security rights in the same asset, it is difficult or impossible for a grantor to grant more than one security right in the same asset and thus to fully utilize the value of its assets to obtain secured credit (see paras. 2 and 5 above).

17. Some legal systems have adopted a special priority rule with respect to certain types of encumbered assets. For example, in some jurisdictions, effectiveness of a security right in receivables against third parties and competing claims in receivables are based on the time that the debtors on the receivables ("the account debtors") are notified of the existence of the security right. However, this system is not conducive to the promotion of low-cost secured credit for a number of reasons. First, it does not permit the creditor to determine, with a sufficient degree of certainty at the time it extends credit, whether there are any competing security rights in the receivables. Second, the system does not provide an efficient way of obtaining security rights in future receivables because notification of the account debtors on future receivables is not possible at the time of the initial extension of credit and therefore account debtors on the future receivables must be notified as the receivables arise. Third, in the case of a multiplicity of account debtors, notification may be costly. Fourth, many grantors may not wish to have their customers directly notified of the existence of a security right in their receivables.

3. Scope of priority rules

18. Because of the importance of priority rules, a secured transactions regime should incorporate a set of priority rules that are comprehensive in scope, covering a broad range of existing and future secured obligations and encumbered assets, and provide ways for resolving priority conflicts among a wide variety of competing claimants (both consensual and non-consensual). As noted in paragraph 1 above, a comprehensive set of priority rules not only serves to rank competing claims in the same asset, but also determines when one person may take an asset free from the claims of all other competing claimants.

(a) Secured obligations affected

19. In order to determine the amount of credit to be extended and the relevant terms, a creditor must be able to establish, at the time of the conclusion of the secured transaction, how much of its claim will be accorded priority.

20. Some legal systems limit this priority to the amount of debt existing at the time of the creation of the security right. The advantage of this approach is that it may (though not necessarily) match priority with the contemplation of the parties at the time of creation. The disadvantage of this approach is that it requires creditors to conduct additional due diligence (e.g. searches for new registrations) and to execute

additional agreements and make additional registrations for amounts subsequently advanced. This is particularly problematic because one of the most effective means of providing secured credit is on a revolving basis, since this type of credit facility most efficiently matches the grantor's unique borrowing needs (see Example 2 in A/CN.9/WG.VI/WP.11/Add.1, paras. 23-25, and Add.2, para. 7). This problem may be solved by giving future advances the same priority that is afforded to advances made at the time that the security right is first created. In the case of credit extended for the delivery of goods or services in instalments, the solution lies in treating the entire claim as coming into existence when the contract is signed and not upon each delivery of goods or services.

21. Other legal systems limit priority to the maximum amount specified in the notice registered in a public registry with respect to a security right in order to avoid tying up all the grantor's assets with one creditor and thus reducing the willingness with which subsequent creditors may extend credit to the grantor (see A/CN.9/WG.VI/WP.14, para. 38).

22. Yet other legal systems accord priority to all extensions of credit, even advances made after the creation of the security right, and for all contingent obligations that may arise after the creation of the security right, without the need to specify a maximum amount. In such systems, a security right may extend to all secured monetary and non-monetary obligations owed to the secured creditor and secured by the security right, including principal, costs, interest and fees, and including performance obligations and other contingent obligations. Priority is unaffected by the date on which an advance or other obligation secured by the security right is made or incurred (i.e. a security right may secure future advances under a credit facility with the same priority as advances made under the credit facility contemporaneously with the creation of the security right).

(b) After-acquired property

23. As discussed in greater detail in chapter IV (see A/CN.9/WG.VI/WP.11/Add.2, paras. 16-18), in some legal systems, a security right may be created in property that the grantor may acquire in the future. Such a security right is obtained automatically at the time the grantor acquires the property without any additional steps being required at that time. As a result, the costs incident to the grant of a security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory which is continuously acquired for resale and receivables which are collected and regenerated on a continual basis (see Example 2 in A/CN.9/WG.VI/WP.11/Add.1, paras. 23-25) and equipment which is replaced in the normal course of the grantor's business.

24. The allowance of security rights in after-acquired property raises the question of whether the priority dates from the time of the initial grant (e.g. the date on which the security right first becomes effective against third parties) or from the time the grantor acquires the property. Different legal systems address this matter in different ways. The approach of some legal systems depends on the status of the creditor competing for priority (with priority dating from the date of the initial grant vis-à-vis other consensual secured creditors, and from the date of acquisition vis-à-vis all other creditors). It is generally accepted that dating priority from the initial grant, rather than from the date the grantor acquires rights in the after-acquired assets, is the most efficient and effective approach in terms of

promoting the availability of low-cost secured credit (see, for example, article 8 (2) of the United Nations Assignment Convention).

25. Effective secured transactions regimes specify that a security right in after-acquired assets of the grantor has the same priority as a security right in assets of the grantor owned or existing at the time the security right is initially made effective against third parties.

(c) Proceeds

26. If the creditor has a security right in proceeds and civil fruits of the original encumbered asset, issues will arise as to the priority of that security right as against other competing claimants. Competing claimants with respect to proceeds may include, among others, another creditor of the grantor who has a security right in the proceeds and a creditor of the grantor who has obtained a right by judgement or execution against the proceeds (as to what constitutes "proceeds", see A/CN.9/WG.VI/WP.11/Add.2, paras. 30-34).

27. Property that constitutes proceeds to one secured creditor may constitute original encumbered assets to another secured creditor. For example, Creditor A may have a security right in all of the grantor's receivables by virtue of its security right in all of the grantor's existing and future inventory and the proceeds arising upon the sale or other disposition thereof, and Creditor B may have a security right in all of the grantor's existing and future receivables as original collateral. If the grantor later sells on credit inventory that is subject to the security interest of Creditor A, both creditors have a security right in the receivables generated by the sale: Creditor A has a security right in the receivables as proceeds of the encumbered inventory, and Creditor B has a security right in the receivables as original encumbered assets.

28. A comprehensive secured transactions regime must answer several questions with respect to competing claims of the above-mentioned secured creditors. One question is whether the right of Creditor A in the receivables as proceeds of inventory is effective not only against the grantor but also against competing claimants. The answer to this question must be affirmative in most circumstances. Otherwise, the value of the original encumbered assets (i.e. the inventory) would be largely illusory. Security rights provide economic security to a secured creditor only to the extent that the secured creditor has the right to apply the economic value of the encumbered assets to its secured obligation prior to other competing claimants. Once the inventory in our example is sold, the economic value of the inventory is, from the creditor's standpoint, embodied in the receivables or other proceeds arising from the sale, and should therefore be available in the first instance to Creditor A.

29. A second question is the extent to which the right to proceeds extends to proceeds of proceeds; for example, the question of whether a creditor with a security right in receivables as proceeds of inventory would also have a security right in the money received when the receivables are collected by the grantor. The answer to this question must also be affirmative in most cases, because a contrary rule would enable the grantor to easily defeat a secured creditor's right to proceeds.

30. A third question is whether the right to proceeds extends only to identifiable proceeds (e.g. whether a security right in proceeds consisting of money is extinguished once the money is commingled with other funds in a bank account). As

to this issue, many jurisdictions have adopted various "tracing" rules to determine when funds deposited in a bank account may properly be considered to be identifiable as proceeds of a security right.

31. Considerations that have led some jurisdictions to require registration or another act in order for a security right in particular property to be effective against third parties have also led some of those jurisdictions to require an additional act to make the right in the proceeds of such property effective against third parties.

32. In some cases, the additional act is a registration as to the proceeds, whereas in other cases it is a different act (such as possession in the case of a negotiable instrument). In cases in which an additional act is required, the legal regime should provide a period of time after the transaction generating the proceeds in which the creditor may perform such act without losing its priority in the proceeds.

33. Although determination of whether an additional act is necessary in order for a security right in proceeds to be effective against third parties is quite important, that determination alone is not sufficient to resolve the relative rights of the holder of such security right and other creditors in proceeds. Priority rules are needed to determine the relative priority of the secured creditor's right in proceeds vis-à-vis the rights of competing claimants.

34. The priority rules may differ depending on the nature of the competing claimant. For example, when the competing claimant is another secured creditor, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to the original encumbered asset and the policies that generated those rules. In a legal system in which the first right in particular property that is reflected in a registration has priority over competing rights, that same rule could be used to determine the priority when the original encumbered asset has been transferred and the secured creditor now claims a right in proceeds. If a registration was made with respect to the right in the original encumbered asset before the competing claimant made a registration with respect to the proceeds, the first security right could be given priority.

35. In cases in which the order of priority of competing rights in the original encumbered asset is not determined by the order of registration (as is the case, for example, with purchase-money security rights that enjoy a super priority), a separate determination will be necessary for the priority rule that would apply to the proceeds of the original encumbered asset.

36. Priority may also depend on other factors when the competing claimant is a judgement creditor (see paras. 56-61) or an insolvency representative (see paras. 92-93).

4. Priority of security rights that are not effective against third parties

37. As discussed above (para. 18), an effective secured transactions regime should have rules for determining the relative priority between a secured creditor and a broad range of competing claimants. The results may differ depending upon whether the security right involved is or is not effective against third parties. Security rights that are effective against third parties are generally entitled to the highest level of protection, but security rights that are not effective against third parties are nevertheless entitled to a degree of protection in some circumstances.

(a) Unsecured creditors

38. The grantor will often incur debts that are not secured by security rights in any of the debtor's assets. In fact, these general unsecured claims often comprise the bulk of the grantor's outstanding obligations.

39. It is generally accepted that giving secured creditors priority over unsecured creditors is necessary to promote the availability of secured credit, and that a secured creditor should therefore have the right to derive the economic value of its security rights in preference to the claims of other creditors of the grantor who do not have a security right in the grantor's assets. Unsecured creditors can take other steps to protect their interests, such as monitoring the status of the credit, charging interest on past due amounts or obtaining a judgement with respect to their claims (as discussed in section 5 (d) below) in the event of non-payment. In addition, obtaining secured credit can increase the working capital of the grantor, which in many instances benefits the unsecured creditors by increasing the likelihood that the unsecured debt will be repaid. In fact, advances made under a secured revolving working capital loan facility (see A/CN.9/WG.VI/WP.11/Add.1, paras. 23-25) are often the source from which a company will pay its unsecured creditors in the ordinary course of its business.

40. Thus, an essential element of an effective secured credit regime is that secured claims, properly created, have priority over general unsecured claims. Notwithstanding this fact, some jurisdictions have adopted an exception to this doctrine in the case of an all-asset security (see A/CN.9/WG.VI/WP.11/Add.2, paras. 23-25).

41. Another question that arises is whether a security right should be accorded priority over unsecured credit even if the security right has not become effective against third parties. Under some legal regimes, the answer to this question will depend upon whether the security right is being enforced in the context of an insolvency proceeding filed by or against the grantor of the security right. If it is, the insolvency representative may be empowered to invalidate security rights that have not become effective against third parties, and if such security rights are invalidated, the obligations that they secure will be treated as unsecured claims. On the other hand, a security right that is not effective against third parties may nevertheless be effective against the grantor, and may be enforced by the secured creditor against the grantor outside of the context of the grantor's insolvency proceedings.

(b) Secured creditors

42. As discussed above (see paras. 2 and 5), many legal systems allow the grantor to grant more than one security right in the same asset, basing the relative priority of such security rights on the priority rule (first-to-file or other rule) in effect under such system or on the agreement of the creditors (see paras. 94-95). Allowing multiple security rights in the same asset in this manner enables a grantor to use the value inherent in the asset to obtain credit from multiple sources, thereby unlocking the maximum borrowing potential of the asset.

43. Secured transactions regimes that distinguish between a security right that is effective against third parties and one that is not effective also generally provide that, even though both security rights are effective against the grantor, the security

right that is effective against third parties has priority over the security right that is not effective against third parties, regardless of the order in which such security rights were created. To hold otherwise would be to render meaningless the concept of effectiveness against third parties.

44. If, on the other hand, both security rights are not effective against third parties but are nonetheless effective against the grantor, priority is determined in the order in which they were created.

5. Priority of security rights that are effective against third parties

(a) Unsecured creditors

45. As discussed above (see paras. 38-41), it is a fundamental principle of secured transactions law in many jurisdictions that a security right that is effective against third parties is effective against unsecured creditors of the grantor.

(b) Secured creditors

46. In many legal systems, as between two security rights in the same encumbered asset that are effective against third parties, subject to limited exceptions discussed in section 5 (c) below, priority is determined by the order in which their respective third party effectiveness steps occurred, even if one or more of the requirements for the creation of a security right was not satisfied at such time.

(c) Holders of purchase-money security rights

47. Typically, the grantor acquires its assets by purchasing them. In some situations, the purchase is made on credit provided by the seller or is financed by a lender, in each case secured by security rights in the purchased assets. This type of financing is referred to as "purchase-money financing" and the security rights securing such financing are referred to as "purchase-money security rights" (see A/CN.9.WG.VI/WP.11/Add.1, para. 17 (b) and 19-22 and A/CN.9.WG.VI/WP.9/Add.1, paras. 35-45). In these situations, consideration must be given to the priority of such purchase money rights vis-à-vis security rights in the same goods held by other parties.

48. Recognizing that purchase-money financing is an effective means of providing businesses with capital necessary to acquire specific goods, many legal systems provide that holders of purchase-money security rights have priority over other creditors (including creditors that have an earlier-in-time registered security right in the goods) with respect to goods acquired with the proceeds of the purchase-money financing, as long as a notice of the purchase-money security right is registered within an appropriate time (which may involve a "grace period" in the case of certain types of assets).

49. In these legal systems, this heightened priority (sometimes referred to as a "super priority") is a significant exception to the first-to-file priority rule discussed in section 2 (a) above and is important in promoting the availability of purchase-money financing. Businesses often grant security rights in all or some of their existing and after-acquired inventory and equipment to obtain financing. In these situations, if purchase-money security rights were not afforded a heightened priority, purchase-money financiers would not be able to place significant reliance

on their security rights in the purchased goods because they would rank behind existing security rights in the same goods. In Example 1 (see A/CN.9/WG.VI/WP.11/Add.1, paras. 19-22), Vendor A, Lender A and Lessor A would each be reluctant to provide purchase-money financing if their security rights in the goods financed ranked behind the existing security rights of Lender B in Example 2 (see A/CN.9.WG.VI/WP.11/Add.1, para. 25).

50. Providing a heightened priority for purchase-money security rights is generally not considered to be detrimental to the grantor's other creditors, because purchase-money financing does not diminish the estate (i.e. the net assets or net worth) of the grantor, but instead enriches the estate with new assets purchased. For example, the security position of Lenders B in Example 2 would not be diminished by a purchase-money financing of inventory, because Lender B still has all of its encumbered assets plus a security right subordinate to the purchase-money security right in the new goods financed by the purchase-money credit transaction.

51. In order to promote the availability of purchase-money financing without discouraging general secured credit, it is important that the heightened priority afforded to purchase-money security rights only apply to the goods acquired with such purchase-money and not to any other assets of the grantor.

52. In some legal systems, purchase-money security rights are not subject to registration (on the basis, inter alia, that vendors of goods may be unsophisticated parties who should not be expected to file or search in the register). However, in other legal systems, purchase-money security rights are subject to registration in order to avoid other creditors mistakenly relying on assets subject to purchase-money security rights (see A/CN.9/WG.VI/WP.14, paras. 56-57).

53. From the perspective of a competing creditor, requiring a notice of such purchase-money security rights to be registered at the time they were obtained would be beneficial. This would mean that any creditor could search the registration system and determine with certainty, whether any of the grantor's existing assets are, at the time of the search subject to purchase-money security rights. However, in order to facilitate on-the-spot financing in the equipment sales and leasing sectors, some systems provide a grace period for purchase-money registrations where the encumbered assets consist of equipment. To most effectively balance competing interests, this grace period must be long enough so that the registration requirement is not an undue burden to purchase-money financiers, but short enough so that other secured creditors are not subject to long periods before they are able to search the registry and determine if any competing security rights exist.

54. Typically, such a grace period does not apply to registrations with respect to purchase-money security interests in inventory. Instead, in order to obtain a super priority in inventory, in some legal systems, the holder of such a security right must, in addition to registration, give notice of its security right to other existing holders of security rights before the goods come into the grantor's possession. This notice generally takes the form of a one-time notice given at the inception of the purchase-money financing arrangement, rather than a notice at the time of each purchase of goods financed by the purchase-money financier. The argument in favour of requiring such notice is that existing inventory financiers should be put on notice of the purchase-money rights so that they will not make additional loans against the debtor's existing inventory in the mistaken belief that they would have a first

priority in such inventory. To otherwise eliminate this danger, such financiers would need to check the register daily before each new advance against inventory to ascertain that there were no claimed purchase-money rights in the inventory (a circumstance that could significantly increase the cost of such financing), and even checking daily would not suffice if a grace period were afforded to the purchase-money security rights.

55. An important policy decision that must be made in fashioning a super priority rule for purchase-money financing is whether such a priority should be available only to sellers of goods, or whether it should also extend to banks and other lenders who finance the acquisition of goods. The arguments in favour of limiting the priority to vendors tend to be historical, in that supplier-financing (e.g. in the form of retention of title arrangements) was developed as a low-cost and efficient alternative to bank financing. A principal argument in favour of extending the priority to banks and other lenders is that such equal treatment enhances competition, which in turn should have a positive impact upon both the availability and cost of credit.

(d) Judgement creditors

56. Many legal systems provide that a general unsecured creditor who has obtained a judgement with respect to its claim and has taken the actions prescribed by law to enforce the judgement (such as seizing specific property or registering the judgement), has the equivalent of a security right in that property. This right effectively gives the judgement creditor priority over general unsecured creditors of the grantor with respect to such property.

57. Judgement creditors are given this priority over other unsecured creditors in recognition of the legal steps they have taken to enforce their claims. This is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement. However, to avoid giving judgement creditors excessive powers in legal systems where a single creditor may institute insolvency proceedings, insolvency laws provide that security rights arising from judgements made within a specified period of time prior to the insolvency proceeding may be avoided by the insolvency representative.

58. Where a judgement creditor is given the equivalent of a security right, an existing creditor with an earlier-in-time consensual security right in certain assets would have an interest in making sure that its security right retains its priority over the security right obtained by a judgement, particularly with respect to assets it has already relied upon in extending credit. At the same time, the judgement creditor has an interest in receiving priority with respect to assets that have sufficient value to serve as a source of repayment of its claim.

59. Many legal systems that have a registration system rank priority in this situation by time of registration of the security right, i.e. an earlier in time registered consensual security right in property will have priority over a subsequent security right in the same property obtained by judgement. Conversely, granting a consensual security right in the property after a creditor has obtained some form of a judgement security right will result in a security right that is subordinate to the existing judgement security right. This approach is generally acceptable to creditors as long as the judgement security right is made sufficiently public so that creditors

can become aware of it in an efficient manner and factor its existence into their credit decision before extending credit.

60. There is generally an exception to this rule when it is applied to future advances (discussed in greater detail in section 3 (a) above). While a previously registered security right will customarily have priority over a judgement security right with respect to credit advanced prior to the date that the judgement security right becomes effective, it will generally not have priority over the judgement security right with respect to any credit advanced after such effective date (unless such credit had been committed prior to the effective date of the judgement). For example, in Example 2 (see A/CN.9/WG.VI/WP.11/Add.1, para. 25), Lender B makes loans to ABC which are secured by all of ABC's existing and future receivables and inventory. If an unsecured creditor obtains a judgement against ABC thereby obtaining a security right in ABC's inventory, Lender B's security right in the inventory would have priority over the judgement security right with respect to loans that Lender B made prior to the date that the judgement became effective, as well as loans that Lender B made within a specified period following the effective date of the judgement. However, the judgement security right would have priority with respect to any additional loans made by Lender B after the specified period, unless Lender B had committed, prior to the effective date of the judgement, to extend such additional loans).

61. To protect existing secured creditors from making additional advances based on the value of assets subject to judgement security rights, there should be a mechanism to put creditors on notice of such judgement security rights. In many jurisdictions in which there is a registration system, this notice is provided by subjecting judgement security rights to the registration system. If there is no registration system or if judgement security rights are not subject to the registration system, the judgement creditor might be required to notify the existing secured creditors of the judgement. In addition, the law may provide that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement security right is registered (or after the creditor receives notice), so that the creditor can take steps to protect its interest accordingly. The less time an existing secured creditor has to react to the existence of judgement security rights and the less public such judgement security rights are made, the more their potential existence will negatively affect the availability and cost of credit facilities that provide for future advances.

(e) Buyers of encumbered assets

62. When a grantor sells assets that are subject to existing security rights, the buyer has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold (unless the secured creditor has consented to the sale). It is important that priority rules address both of these interests, and that an appropriate balance be struck. If the rights of a secured creditor in particular assets are put at risk every time its grantor sells such assets, their value as security would be severely diminished, and the availability of low-cost credit based on the value of such assets would be jeopardized .

63. It is sometimes argued that the secured creditor is not harmed by a sale of the assets free of its security right so long as it retains a security right in the proceeds of

the sale. However, this would not necessarily protect the secured creditor, because proceeds are often not as valuable to the creditor as the original encumbered assets. In many instances, the proceeds may have little or no value to the creditor as security (e.g. a receivable that cannot be collected). In other instances, it might be difficult for the creditor to identify the proceeds, and its claim to the proceeds may, therefore, be illusory. In addition, there is a risk that the proceeds, even if of value to the secured creditor, may be dissipated by the seller who receives them, leaving the creditor with nothing. Jurisdictions have taken a number of different approaches to achieving this balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession.

i. The ordinary course of business approach

64. One approach taken in many jurisdictions is to provide that sales of encumbered assets in the form of inventory made by the grantor in the ordinary course of its business will result in the automatic extinction of any security rights that the secured creditor has in the assets without any further action on the part of the buyer, seller or secured creditor. The corollary to this rule is that sales of inventory outside the ordinary course of the grantor's business will not extinguish any security rights, and the secured creditor may, upon a default by the grantor (see A/CN.9/WG.VI/WP.14/Add.2, para. 5, definition of "default"), enforce its security right against the inventory in the hands of the buyer (unless, of course, the secured creditor has consented to the sale). Where the security agreement so provides, the sale itself may constitute a default entitling the secured creditor to enforce its security rights; otherwise, the secured creditor cannot do so until default has occurred.

65. In order to qualify as a "buyer in the ordinary course of business," the seller of the assets must be in the business of selling assets of that kind. In addition, the buyer must not have knowledge that the sale violates the security or other rights of another person in the assets, as would be the case, for example, if the buyer had actual knowledge that the sale was prohibited by the terms of the security agreement between the seller and a lender to the seller who held security rights in the assets (see A/CN.9/WG.VI/WP.11/Add.1, para. 17 (aa), definition of "buyer in the ordinary course of business").

66. This approach arguably provides a simple and transparent basis for determining whether goods are sold free and clear of security rights. For example, the sale of an automobile by an automobile dealer to a consumer is clearly a sale of inventory in the ordinary course of the dealer's business, and the consumer should automatically take the car free and clear of any security rights in favour of the dealer's creditors. On the other hand, a sale by the dealer of many cars in bulk to another dealer would presumably not be in the ordinary course of the dealer's business. This approach is consistent with the commercial expectation that the grantor will sell its inventory of goods (and indeed must sell it to remain viable), and that buyers of the goods will take them free and clear of existing security rights. Without such an exemption, a grantor's ability to sell goods in the ordinary course of its business would be greatly hampered, because buyers would have to investigate claims to the goods prior to purchasing them. This would result in significant transaction costs and would greatly impede ordinary course transactions.

67. To promote such ordinary course transfers, and to remove the uncertainty caused by making priority dependent upon the knowledge of the prior security right (see para. 11), many legal systems provide that buyers in such transactions obtain the assets free and clear of any security right even if the buyer had actual knowledge of the security right. This consideration is so important that some jurisdictions even permit a buyer of goods with actual knowledge of a security right in the goods to take free of such security right even if the security right is not effective against third parties. However as noted above (see para. 65), in some jurisdictions a buyer is not permitted to take free of a security right if the buyer had knowledge that the sale was made in violation of an agreement between the seller and its creditor that the assets would not be sold without the consent of the creditor.

68. With respect to sales that are outside of the ordinary course of the grantor's business, as long as the creditor's security right is subject to registration in a reliable and easily accessible registration system, the buyer may protect itself by searching the registration system to determine whether the asset it is purchasing is subject to a security right, and if so, seek a release of the security right from the secured creditor. Low-cost items are in some systems exempted from this rule because the search costs imposed on potential buyers may not be justified for such items. On the other hand, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in setting arbitrary limits which would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors.

69. In some countries that have a registration system that is searchable only by the grantor's name, rather than by a description of the encumbered assets, a purchaser who purchases the assets from a seller who previously purchased the assets from the grantor (a "remote purchaser") obtains the assets free of the security rights granted by such grantor. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset, and accordingly, have no reason to conduct a search against the previous owner.

70. A possible disadvantage of the ordinary course of business approach is that it might not always be clear to a buyer (particularly in international trade) what activities might be within or not within the ordinary course of the seller's business. Another possible disadvantage might be that, if this rule were applied only to sales of inventory and not of other goods, there could be confusion on the part of the buyer as to whether the goods it is buying constitute inventory from the seller's point of view. On the other hand, it should be noted that, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved, and in these situations the ordinary course of business approach would be consistent with the expectations of the parties. In addition, this approach facilitates commerce and allows secured creditors and buyers to protect their respective interests in an efficient and cost-effective manner without undermining the promotion of secured credit. Moreover, these possible disadvantages would not apply to retail trade (where the sale is presumed to be in the ordinary course of the seller's business, and a buyer is not required to check the registry), while in other situations buyers could protect themselves by negotiating

with sellers (and their secured creditors) to obtain the assets free of any security rights.

ii. Other approaches

71. Another approach to this problem taken by some jurisdictions is to provide that a buyer of goods will take free of any security rights in the goods if the buyer purchases the goods in good faith (i.e. with no actual or constructive knowledge of the existence of the security rights). One argument in favour of this approach is that good faith is a notion known to all legal systems, and that there exists significant experience with its application both at the national and international level. It has also been argued that a presumption should exist that a buyer is acting in good faith unless it is proven otherwise.

72. A number of other approaches are possible that seek to blend the "good faith" and the "ordinary course of business" approaches. One such approach is to provide that the principal criterion should be the "ordinary course of business" test, but that the "good faith" test should be applied in the situation of the "remote purchaser" described above (see para. 69). In that case, the remote purchaser would take free of security rights created by the party from whom its direct seller purchased the goods, unless the remote purchaser had actual or constructive knowledge of the security rights. Even though this approach might inadvertently open the way to abuse, since a grantor could frustrate the rights of the secured creditor by selling the goods outside the ordinary course of business to a party who would then sell them in the ordinary course of business, there is a strong policy reason to protect remote purchasers. One approach to protect secured creditors in this circumstance is to make the circumventing grantor liable to the secured creditor for damages.

(f) Holders of reclamation claims

73. In many legal systems, a supplier who sells goods on unsecured credit may reclaim the goods from the buyer within a specified period of time (known as the "reclamation period"). This reclamation is possible after the supplier discovers that the buyer has become insolvent. Upon the return of the goods to the seller, the sale agreement under which the goods were originally sold to the buyer is generally deemed terminated.

74. Although the supplier will want the reclamation period to be as long as possible to protect its interests, other creditors will be reluctant to provide credit based on assets subject to potential reclamation claims. Moreover, if the supplier is truly concerned about the credit risk, the supplier could insist upon a purchase-money security right in the goods that it supplies on credit. Accordingly, although a reclamation claim is important so that suppliers can have some rights in the goods that they supply on unsecured credit, the reclamation period should be brief (30-45 days at most) so that it does not impede lending generally.

75. An important policy consideration is whether reclamation claims relating to specific goods should have priority over pre-existing security rights in the same goods. In other words the question is whether, if the inventory of the buyer, (including the goods sought to be reclaimed), is subject to effective security rights in favour of a third party financier, the reclaimed goods should be returned to the seller free of such security rights. In some jurisdictions, the reclamation has a

retroactive effect, placing the seller in the same position it was prior to the sale (i.e. holding goods that were not subject to any security rights in favour of the buyer's creditors). However, in other jurisdictions the goods remain subject to the pre-existing security rights, on the basis that any other result would be unfair to a pre-existing creditor of the buyer who had relied on the existence of such goods in extending credit, and would also promote uncertainty and thereby discourage inventory financing.

76. In many jurisdictions, reclamation claims in specific goods are extinguished when the goods are incorporated into other goods in the manufacturing process or otherwise lose their identity, or are sold to a third party.

(g) Lessees

77. Priority disputes sometimes arise between the holder of a security right in an asset granted by the owner/lessor of the asset that is effective against third parties and a lessee of such asset. The principal issue in this situation is whether, if the holder of such security right enforced it, the lessee could nevertheless continue using the asset so long as it continued to pay rent and otherwise abide by the terms of the lease.

78. To address this situation, some jurisdictions have adopted the approach that a lessee of goods takes priority over a security right in the goods created by the lessor if the lease is entered into in the ordinary course of the lessor's business, even if the lessee has actual knowledge of the existence of the security right. Thus, even if the secured creditor in this situation enforced its security right and sold the lessor's interest to a third party at a foreclosure sale, the third party would take title to the asset subject to the lease, and the lessee would be entitled to continue to use the asset in accordance with the terms of the lease.

79. An exception is sometimes made if, at the time the lessee entered into the lease, the lessee has actual knowledge that the lease violates the rights of the secured creditor, as would be the case if the lessee knew that the security agreement creating such security right specifically prohibited the grantor from leasing the property. However, the mere knowledge of the existence of the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the priority of the lessee.

(h) Holders of negotiable instruments and negotiable documents

80. Many secured transactions regimes have adopted a special priority rule for negotiable instruments (such as promissory notes) and negotiable documents (such as negotiable warehouse receipts and bills of lading) under which holders of such property may take the property free of the claims of other persons, including the holders of valid security rights. This special status accorded to holders of negotiable instruments and documents is a reflection of the importance of the concept of negotiability in those jurisdictions, and the desire to preserve such concept. Usually the law (either the secured transactions regime or other applicable law) only grants such special status to holders who meet certain specified standards of good faith (e.g. to assure that they are not acting in collusion with the person from whom they received the property).

(i) Holders of rights in money

81. Many secured transactions regimes accord a similar status to a person who gives value for money and has possession of the money, permitting such person to take the money free of the claims of other persons, including the holders of valid security rights in the money. This special priority rule is designed to preserve the free flow of money as an unencumbered medium of exchange. Different rules often apply where the money is deposited in a bank account, or where it can be established that the holder of the money colluded with the grantor to defeat the claim of the holder of security rights in, or other claims to, the money.

(j) Statutory (preferential) creditors

82. In many jurisdictions, as a means of achieving a general societal goal (e.g. protection of tax revenue or employee wages), certain unsecured claims are given priority, within or even outside insolvency proceedings, over other unsecured claims and, in some cases, over secured claims (including secured claims previously registered). For example, to protect claims of employees and the government, claims for unpaid wages and unpaid taxes are in some jurisdictions given priority over previously existing security rights. Because societal goals differ from jurisdiction to jurisdiction, the precise nature of these claims (e.g. whether they relate to taxes, employee-related claims or other types of claims), and the extent to which they are afforded priority, also differ.

83. The advantage of establishing these preferential claims is that a societal goal may be furthered. The possible disadvantage is that these types of priorities can proliferate in a fashion that reduces certainty among existing and potential creditors, thereby impeding the availability of low-cost secured credit. In addition, even if the preferential claims can be ascertained with certainty by an existing or potential creditor, such claims (whether arising within or outside of insolvency proceedings) will adversely affect the availability and cost of secured credit: because such claims diminish the economic value of an asset to a secured creditor, creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate, or by withholding the estimated amount of such claims from the available credit.

84. To avoid discouraging secured credit, the availability of which is also a societal goal, the various societal goals should be carefully weighed in deciding whether to provide a preferential claim. Preferential claims should be as limited as possible, and permitted only to the extent that there is no other effective means of satisfying the underlying societal objective and when the jurisdiction has determined that the impact of such claims on the availability of low-cost credit is acceptable. For example, in some jurisdictions, tax revenue is protected through incentives on company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund.

85. If preferential claims exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims and to protect itself. Some jurisdictions have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other jurisdictions have achieved it by requiring that preferential claims be registered in a public registry, and according priority to such claims only over

security rights registered thereafter. In those jurisdictions, priority is awarded to security rights that were either registered before the preferential claims are registered, or security rights that are created within a specified period (such as 45-60 days after the preferential claims are registered), if the pre-existing security rights secure a commitment to provide future advances. However, a problem with adopting a registration requirement with respect to some preferential claims that arise immediately prior to an insolvency proceeding is that it may be difficult to calculate their amount or to file in time.

(k) Holders of rights in assets for improving and storing encumbered assets

86. Some legal systems provide that creditors who have added value to goods in some way, such as by repairing them, have security rights in the goods and that such security rights generally rank ahead of other security rights in those goods. This priority rule has the advantage of inducing those who supply such value to continue in their efforts, and also has the advantage of facilitating the maintenance and preservation of encumbered assets. As long as the amount that these security rights secure is limited to an amount that reflects the value by which the encumbered asset has been enhanced, such security rights and their elevated priority should not be objectionable to existing secured creditors.

87. Some systems also provide that creditors, such as landlords and warehousemen, who store encumbered assets or who lease to a grantor the premises on which the encumbered assets are stored, have security rights in the encumbered assets to secure rental and storage obligations, and such security rights often rank ahead of other secured claims in the same encumbered assets.

88. In many jurisdictions, the rights described in the preceding two paragraphs are not subject to any registration requirement, and their existence can only be discerned through due diligence on the part of a prospective creditor. As a result, these security rights are often referred to as being “secret”. While secret security rights have the advantage of protecting the rights of the parties to whom they are granted without requiring such parties to incur the costs associated with registration, they pose a significant impediment to secured credit because they limit the ability of creditors to ascertain the existence of competing security rights. As discussed in chapter V (see A/CN.9/WG.VI/WP.14, paras. 56-59), consideration should be given to requiring that notice of such security rights be registered in the security rights registration system.

89. If legislators give priority to the rights of such service providers, a question arises as to whether these rights should be limited in amount and recognized as priority claims only in certain circumstances. One approach may be to limit these rights in favour of service providers in amount (such as one month’s rent in the case of landlords) and to recognize their priority over pre-existing security rights only where the value added directly benefits the holders of the pre-existing security rights. Another approach may be to avoid introducing such limitations, since doing so would unfairly inhibit the availability of credit to such service providers. In addition, introducing such limitations may be unnecessary since secured creditors can protect themselves against such service claims in various ways, such as by contractually limiting the extent to which their grantors may enter into such service contracts, or by reserving a sufficient portion of the available credit to enable the creditor to pay the service providers in the event that the grantor fails to do so.

(l) Holders of security rights in real property to which fixtures are attached

90. To the extent that a secured transactions regime permits security rights to be created in fixtures (the approach recommended by this Guide), the regime should also establish rules governing the relative rights of a holder of security rights in fixtures vis-à-vis persons who hold rights with respect to the related immovable property (such as a person, other than the grantor, who has an ownership interest in the immovable property, a purchaser of the immovable property or a creditor who has security rights that extend to the immovable property as a whole). Such priority rules might usefully address situations such as where the security rights in the fixtures were created prior to the creation of the rights in the immovable property, and vice versa, where security rights in goods were created before the goods became fixtures and where the security rights in the goods were created after the goods became fixtures. When developing priority rules with respect to fixtures, care should be taken not to unnecessarily disturb well-established principles of real property law.

(m) Donees

91. The position of a recipient of an encumbered asset as a gift (a "donee") is somewhat different from that of a buyer or other transferee for value. Because the donee has not parted with value, there is no objective evidence of detrimental reliance on the grantor's apparently unencumbered ownership. As a result, in a priority dispute between the donee of an asset and the holder of a security right in the asset granted by the donor, a strong argument exists in favour of awarding priority to the secured creditor, even in circumstances where the security right was not otherwise effective against third parties. On the other hand, there may be valid grounds for departing from this principle in specific situations, such as where the donee has changed its position based upon the gift, subject to the right of the secured creditor and the donor's insolvency representative to challenge the gift under applicable fraudulent conveyance laws where it can be demonstrated that the donee was acting in collusion with the donor to defeat the rights of the secured creditor.

(n) Insolvency representatives

92. It is particularly important that a secured creditor be able to determine what its priority will be in the event that an insolvency proceeding is commenced by or against its grantor, because there most likely will not be sufficient assets to pay all creditors and the encumbered assets may be the creditor's primary, or only, source of repayment. As a result, in deciding to extend credit and in evaluating priority, secured creditors generally place their greatest focus on what their priority will be in an insolvency proceeding of the grantor. Therefore, it is important that the priority of a properly obtained security right not be diminished or impaired in an insolvency proceeding, subject to applicable provisions of the insolvency laws pertaining to preferential claims and avoidance actions. The importance of this point in crafting an effective secured transactions law cannot be over-emphasized. To the extent that secured credit and insolvency laws are not clear on this point, the willingness of creditors to provide secured credit will be seriously diminished.

93. In order to effectively compensate insolvency representatives for their work in the insolvency proceeding, they often are given a super priority preferential claim in

the assets of the insolvent estate. This claim and the extent to which an insolvency representative may be empowered to challenge security rights in various circumstances are discussed in detail in chapter IX.

6. Subordination agreements

94. In many legal systems, priority may be, and frequently is, altered by a secured creditor unilaterally or by private contract with other secured creditors. As an example, Lender A, holding a security right in all existing and after-acquired assets of a grantor under an all-asset security, could agree to permit the grantor to give a first priority security right in a particular asset to Lender B so that the grantor could obtain additional financing from Lender B based on the value of that asset. Such agreements are to be distinguished from subordination agreements between unsecured creditors waiving the principle of equal treatment of their unsecured claims. The recognition of the validity of subordination of security rights unilaterally or by private contract reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention).

95. Such agreements altering priority are perfectly acceptable as long as they affect only the parties who actually consent to such alterations. Subordination agreements should not affect the rights of creditors who are not parties to the agreement. Additionally, it is essential that the priority afforded by a subordination agreement continue to apply in an insolvency proceeding of the grantor, and the insolvency laws should so provide. In fact, in some jurisdictions, such a provision in the insolvency laws may be necessary to empower the courts to enforce subordination agreements, and to empower insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see chapter IX).

7. Relevance of priority prior to enforcement

96. Another important issue pertaining to priority is whether priority only has relevance after the occurrence of a default by the grantor in the underlying obligation or whether priority also has relevance prior to default. Many jurisdictions adopt the former approach, thereby allowing the holder of a subordinate security right (in the absence of a contrary agreement between the first-ranking and subordinate claimants), to receive regularly scheduled payments on its obligation even though the secured obligation having priority has not been paid in full. The argument for this approach is that, in the absence of a contrary agreement and prior to a default, a grantor should be free to dispose of its assets and use the proceeds to pay its obligations as they mature, irrespective of the relative priority of the security rights in such assets. Requiring the subordinate claimant to remit the payment to the first-ranking claimant in the absence of such an express agreement would be a major impediment to the subordinate claimant providing financing.

97. The result may be different if the subordinate claimant received proceeds from the collection, sale or other disposition of the encumbered asset. In that circumstance, some jurisdictions require the subordinate claimant to remit the proceeds to the first-ranking claimant if the subordinate claimant received the proceeds with the knowledge that the grantor was required to remit them to the first-ranking claimant. The rationale behind this rule is similar to the rationale discussed in section 5 (e) above with respect to buyers of encumbered assets.

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 priority 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 places.*]