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## Security Interests

### Recommendations of the draft Legislative Guide on Secured Transactions

#### Report of the Secretary General

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



## **Recommendations of the draft Legislative Guide on Secured Transactions**

### **I. Key objectives**

#### **Purpose**

The purpose of the recommendations on key objectives is to provide a broad policy framework for the establishment and development of an effective and efficient secured transactions law. These recommendations could be included in a preamble of the secured transactions law (hereinafter referred to as “the law”).

#### **Key objectives**

1. The following key objectives should be considered:
  - (a) Promote secured credit;
  - (b) Allow a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions;
  - (c) Obtain security rights in a simple and efficient manner;
  - (d) Recognize party autonomy;
  - (e) Provide for equal treatment of creditors;
  - (f) Validate non-possessory security rights;
  - (g) Encourage responsible behaviour by enhancing predictability and transparency;
  - (h) Establish clear and predictable priority rules;
  - (i) Facilitate enforcement of creditor’s rights in a predictable and efficient manner;
  - (j) Balance the interests of the affected persons; and
  - (k) Harmonize secured transactions laws, including conflict of laws rules.

### **II. Scope of application**

#### **Purpose**

The purpose of the scope provisions of the law should be to specify the parties, the security rights, the secured obligations and the assets to which the law applies.

#### **Parties, security rights, secured obligations and assets covered**

2. The scope of the law should be as broad as possible with respect to the parties, and the types of security rights, secured obligations and encumbered assets covered. Any exceptions should be limited and clearly stated in the law.
3. In particular, the law should apply to:

(a) Legal and natural persons, including consumers, without, however, affecting their rights under consumer-protection legislation;

(b) Property rights created contractually to secure all types of obligations, including future obligations, fluctuating amounts of obligations and obligations described in a generic way;

(c) Possessory and non-possessory security rights in movable property and fixtures securing payment or other performance of one or more obligations, present or future, determined or determinable;

(d) All types of movable assets and fixtures, tangible or intangible, not specifically excluded in the law, including inventory, equipment and other goods, receivables, [negotiable instruments, such as cheques, bills of exchange and promissory notes, negotiable documents, such as bills of lading, bank accounts, letters of credit and intellectual property rights; *[Note to the Working Group: If the Working Group decides that such types of asset should be covered in the draft Guide, it may wish to review the recommendations to ensure that they are appropriate for those assets as well and to add special recommendations where necessary.]*

(e) Security rights acquired by way of transfer of title and all other types of rights securing the payment or other performance of one or more obligations, irrespective of the form of the relevant transaction and whether ownership of the encumbered assets is held by the secured creditor or the grantor, including retention of title, financial leases and hire-purchase agreements; and

(f) To some extent, sales of receivables.

4. The law should not apply to security rights in:

(a) Securities;

(b) Real property, with the exception of fixtures;

(c) Wages;

(d) [...].

*[Note to the Working Group: The Working Group may wish to consider whether a recommendation should be included here at all providing that the law does not override international obligations of the enacting State arising out of treaties or international agreements and if so, whether such recommendation should refer to all or just to specific treaties or international agreements.]*

### **III. Basic approaches to security**

#### **Purpose**

The purpose of the recommendations on basic approaches to security is to specify that the law follows a unitary and functional approach.

### **Unitary approach**

5. The law should include a comprehensive and consistent set of provisions on non-possessory security rights in tangibles and intangibles. The law should also provide for possessory security rights in tangibles.

### **Functional approach**

6. The law should address all devices that perform security functions, including the transfer of title for security purposes, retention of title, financial leases and hire-purchase agreements, in the same way as secured transactions, except to the extent otherwise provided in the law.

## **IV. Creation of the security right as between the parties**

### **Purpose**

The purpose of the provisions of the law dealing with creation is to specify the way in which a security right in movable property is created as between the grantor and the secured creditor.

### **Security agreement**

7. The law should specify that a security right, including a purchase-money security right, is created by agreement between the grantor and the secured creditor.

### **Delivery of possession**

8. The creation of a possessory security right requires, in addition to an agreement, the delivery of possession of the assets to be encumbered to the secured creditor or a third person (other than the grantor or an agent or employee of the grantor) that holds the assets on behalf of the secured creditor.

### **Minimum contents of the security agreement**

9. The law should provide that the security agreement must, at a minimum, identify the secured creditor and the grantor, and reasonably describe the secured obligation and the assets to be encumbered. A generic description of the secured obligation and the encumbered assets should be sufficient.

### **Form**

10. The law should provide that the security agreement by which a non-possessory security right is created must be in writing and signed by the grantor. The law should specify that that requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference (see article 6 of the UNCITRAL Model Law on Electronic Commerce and article 9, para. 2, of the draft Convention on Electronic Contracting).

11. The law should also specify that, unless the law provides otherwise, where the law requires a signature of a person, that requirement is satisfied in relation to an electronic communication if:

(a) A method is used to identify that person and to indicate that person's approval of the information contained in the electronic communication message; and

(b) That method is as reliable as was appropriate for the purpose for which the electronic communication was generated or communicated, in the light of all the circumstances, including any relevant agreement.

*[Note to the Working Group: The Working Group may wish to consider whether recommendation 2 contained in A/CN.9/WG.VI/WP.17/Add.1 should apply to agreements for the creation of both purchase-money and non-purchase money security rights.]*

#### **Assets and obligations subject to a security agreement**

12. The law should make it possible to secure all types of obligations, including future obligations and fluctuating amounts of obligations. It should also make it possible to provide security in all types of asset, including assets which the grantor may not own or have the power to dispose of, or which may not exist at the time of the security agreement, and in proceeds. Any exceptions to these rules should be limited and described clearly in the law.

#### **Proceeds**

13. The law should provide that, unless otherwise agreed by the parties to the security agreement, the security right in the encumbered assets extends to the proceeds to the extent that the proceeds are identifiable in accordance with rules dealing with tracing that are also included in the law. [The security right extends to fruits of encumbered assets, such as [...], only if the parties so provide in the security agreement.]

#### **Fixtures, accessions and commingled goods**

14. The law should provide that a security right may be created in fixtures [under this law or real property law] or accessions, or continue in encumbered assets that become fixtures or accessions.

15. The law should also provide that a security right may not be created in goods that are physically united with other goods in such a way that their identity is lost in a product or mass ("commingled goods"). However, if encumbered assets become commingled goods, the security right becomes a security right in the mass or product (see also rec. 37 on third-party effectiveness and rec. 42 on priority).

#### **Time of creation**

16. The law should provide that a possessory security right is created at the time the grantor delivers possession of the assets to be encumbered to the secured creditor or a third person (other than the grantor or an agent or employee of the grantor) that holds the assets on behalf of the secured creditor, unless the parties otherwise agree.

17. The law should also provide that a non-possessory security right is created at the time the security agreement is made, unless the parties otherwise agree, and a

security right in future property is created at the time grantor acquires rights in such property.

*[Note to the Working Group: Reference is made to possession only as tangibles are subject to possession only. However, if the Working Group decides to apply “control” rules to certain types of tangibles, such as letters of credit and certificates of deposit, a reference to “control” may need to be added to the first sentence after “possession”, in the technical meaning of “control”, i.e. the legal authority to direct the disposition of encumbered assets without the need of any further consent or action by the grantor].*

## V. Effectiveness of the security right against third parties

### Purpose

The purpose of the provisions of the law on the effectiveness of a security right against third parties is to require an additional step before a security right may become effective against third parties so as to:

- (a) Alert third parties dealing with the movable assets of the grantor of the risk that those assets may be encumbered by a security right; and
- (b) Provide a temporal event for ordering priority among secured creditors and between a secured creditor and other classes of competing claimants.

### Methods for achieving third-party effectiveness

18. The law should provide that a security right is effective against third parties only when one of the following events occurs:

- (a) Registration of a notice of the security right in a general security rights registry;
- (b) Dispossession of the grantor if the encumbered assets are specific items of tangible movable property;
- [(c) Transfer of control to the secured creditor if the encumbered assets are [certain intangible obligations, other than receivables, owing to the grantor by a third person] [a bank account];]
- (d) Registration of a notice of the security right in a specialized title registry if the encumbered assets are specific items of movable property for which title is established, under other law of the enacting State, by registration in such a registry;
- (e) Entry of a notation of the security right on the title certificate 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; [or
- (f) ...].

*[Note to the Working Group: The Working Group may wish to consider additional methods for achieving third-party effectiveness (e.g. automatic third-party effectiveness upon creation of a security right in consumer goods. The Working Group may also wish to consider whether, in the case of assets subject to registration in a specialized registry or to a title certificate registration system, in*

*addition to registration in a specialized title registry or a title certificate, registration of a notice in the general secured transactions registry should also be required. The advantage of such an additional registration requirement would be that a search in the secured transactions registry would reveal all security rights in a wide range of assets, including those that are subject to a specialized registration system.]*

19. The law should confirm that different methods for achieving third-party effectiveness may be used for different items or kinds of encumbered assets, whether or not they are encumbered by the same security agreement or by separate security agreements.

#### **Establishment and characteristics of a general security rights registry**

20. The law should provide for the establishment of a general security rights registry having the following characteristics:

- (a) Registration is effected by filing a notice of the security right as opposed to a copy of the security documentation;
- (b) The record of the registry is centralized; that is, it contains all notices of security rights registered under the secured transactions law of the enacting State;
- (c) The registration system is set up to permit the indexing and retrieval of notices according to the name of the grantor or according to some other reliable identifier of the grantor;
- (d) The registry is open to the public;
- (e) Reasonable public access to the registry is assured through such measures as:
  - (i) Setting fees for registration and searching at a cost-recovery level; and
  - (ii) Making available remote modes or points of access;
- (f) The registration system is administered and organized to facilitate efficient registration and searching. In particular:
  - (i) A notice may be registered without verification or scrutiny of the sufficiency of its content;
  - (ii) If the financial and infrastructural capacity of the enacting State permits, notices are stored in electronic form in a computer database;
  - (iii) If the financial and infrastructural capacity of the enacting State permits, registrants and searchers have access to the registry record by electronic or similar means, including electronic data interchange, electronic mail, telex, telephone or telecopy; and
- (g) The law provides rules on the allocation of liability for loss or damage caused by an error in the administration or operation of the registration and searching system.

#### **Required content of registered notice**

21. To constitute a legally effective registration, the law should require the registered notice to contain only:

- (a) The names (or other reliable identifiers) of the grantor and the secured creditor, and their addresses;
- (b) A description of the movable property covered by the notice;
- (c) The term of the registration; and
- [(d) A statement of the maximum monetary amount for which the security right may be enforced [if a State elects that such information is necessary to facilitate subordinate lending.]

#### **Legal sufficiency of grantor name in a registered notice**

22. The law should provide that the name or other identifier of the grantor entered on a registered notice is legally sufficient if the notice can be retrieved by searching the registry record according to the correct legal name or other identifier of the grantor. For this purpose, the law should specify rules for determining the correct legal name or other identifier of individuals and entities.

#### **Legal sufficiency of description of assets covered by a registered notice**

23. The law should provide that a description of the assets covered by a registered notice is legally sufficient if it enables a third person to identify the assets covered by the notice separate from other assets of the grantor.

24. If the assets covered by the notice consist of a generic category or categories of movable property, the law should confirm that a generic description is legally sufficient.

25. If the assets covered by the notice are all the present and after-acquired movable property of the grantor, the law should confirm that it is legally sufficient to describe the charged assets as “all movable property” or by using equivalent language.

#### **Advance registration**

26. The law should confirm that a registration may be made before or after the creation of the security right to which it relates.

#### **One registration for multiple security agreements between the same parties**

27. The law should confirm that a single registration is sufficient for security rights created by all security agreements entered into between the same parties to the extent they cover items or kinds of movable property that fall within the description contained in the registered notice.

#### **Duration and renewal of registration**

28. The law should specify the duration of registration or permit the duration to be selected by the registrant at the time of registration. The law should provide for the right to successively renew the term of a registration.

**Discharge of registration**

29. The law should adopt a summary procedure to enable the grantor to compel discharge of a registration if no security agreement has been completed between the parties or if the security right has been terminated by full payment or performance of all of the secured obligations. The law should also permit discharge of a registration by agreement of the secured creditor and the grantor.

**Additional rights subject to registration**

30. The law should provide that the following rights are effective against third parties only if notice of the right is registered in the general security rights registry:

[(a) The title of a creditor who retains title to goods to secure payment of the purchase price of the goods or its economic equivalent under a financial lease or hire-purchase agreement;] and

(b) The right of an assignee under an outright assignment of receivables;

[(c) The law may also permit registration of a notice in respect of the following rights for purposes of achieving third-party effectiveness:

(i) A lessor under a lease that is not a financing lease but which extends for a term of more than one year;

(ii) A consignor under a commercial consignment in which the goods are consigned to a consignee as agent for sale other than an auctioneer or that a consignee who does not act as a consignee in the ordinary course of business; and

(iii) A buyer under a sale of goods outside the ordinary course of the seller's business where the seller remains in possession of the goods for more than [thirty] [sixty] [ninety] days;]

**Dispossession of the grantor**

31. The law should provide that, for a possessory security right to be effective against third parties, dispossession of the grantor should be actual and not constructive, fictive or symbolic. Dispossession of the grantor is sufficient only if an objective third person can conclude that the encumbered assets are not in the actual possession of the grantor. Possession by a third person constitutes sufficient dispossession only if the third person is not an agent or employee of the grantor and holds possession for or on behalf of the secured creditor.

**Dispossession of the grantor in the case of tangibles represented by a negotiable document of title**

32. The law should provide that, for a possessory security right in tangibles represented by a negotiable document of title to be effective against third parties, delivery of the document to the secured creditor constitutes effective dispossession of the grantor during the time that the tangibles are covered by the document.

**[Transfer of control in [intangible obligations] [bank accounts]**

33. The law should provide that a security right in [certain intangible obligations] [bank accounts] may be made effective against third parties through the transfer of control of the [intangible obligation] [bank account] to the secured creditor.

34. [A person who owes a certain intangible obligation to the grantor] [a depository institution with whom the grantor has a bank account] is required to respond, within a [prescribed] [reasonable] time, to a written demand from a creditor of the grantor for confirmation of whether control over [the performance of the intangible obligation] [the bank account] has been transferred to a secured creditor.]

35. If the secured creditor and the [person owing the intangible obligation] [the depository institution] are the same person, the law should confirm that the secured creditor acquires control as soon as the security right is created.]

**Security rights in proceeds**

36. Where the law recognizes a statutory security right in the identifiable proceeds of the originally encumbered assets, the law should provide that the security right in the proceeds becomes effective against third parties as soon as the right in the proceeds is created as between the parties to the security agreement provided that:

(a) The proceeds take the form of money, negotiable instruments, negotiable documents of title, or receivables [including] [and] bank accounts;

(b) The proceeds are covered by the description contained in a notice registered in the general security rights registry; or

(c) The security right in the proceeds is independently made effective against third parties by one of the methods referred to in recommendation 18 within [...] days after the proceeds arise.

**Security rights in fixtures, accessions and commingled goods**

37. The law should provide that a security right in fixtures, accessions and commingled goods becomes effective against third parties by one of the methods referred to in recommendation 18. [*Note to the Working Group: With respect to security rights in fixtures, the Working Group may wish to consider whether a notation in the real property registry should also be required.*] If a security right is effective against third parties at the time when the encumbered assets become accessions or commingled goods, the security right in the encumbered assets or, in the case of commingled goods, in the product or mass remains effective against third parties.

**VI. Priority of the security right over the rights of competing claimants**

**Purpose**

The purpose of the provisions of the law on priority is to:

(a) Enable a potential secured creditor to determine, in an efficient manner and with a high degree of certainty prior to extending credit, the priority that the security rights would have over competing claimants; and

(b) Enable grantors to create more than one security right in the same asset and to thereby use the full value of their assets to facilitate obtaining credit.

#### **Scope of priority rules**

38. The law should have a complete set of priority rules covering all possible priority conflicts.

#### **Secured obligations affected**

39. The law should provide that the priority accorded to a security right:

(a) Extends to all monetary and non-monetary obligations owed to the secured creditor [up to a maximum monetary amount set forth in the registered notice], including principal, costs, interest and fees, to the extent secured by the security right; and

(b) 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 at the time the security right is made effective against third parties).

#### **Priority in after-acquired property**

40. The law should specify that a security right in after-acquired or after-created 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 made effective against third parties.

#### **Priority in proceeds**

41. The law should provide that a secured creditor's priority with respect to an encumbered asset extends to the proceeds of the asset subject to the requirements of recommendation 36.

#### **Priority in fixtures, accessions and commingled goods**

42. The law should set forth rules governing the relative priority of:

(a) A security right in fixtures over rights with respect to the related immovable property, such as an ownership interest, held by a person other than the grantor, in the immovable property, the right of a purchaser of such immovable property or a security right that extends to the immovable property as a whole;

(b) A security right in accessions over security rights and other rights in the asset to which the accession is affixed; and

(c) A security right in commingled goods over security rights and other rights in the product or mass that results from the commingling.

**Continuity in priority in the case achieving third-party effectiveness by various methods**

43. The law should provide that, if a security right is made effective against third parties by one method, it is also made effective against third parties by another method, priority dates as of the time the first method is completed [provided that there was no time gap between completion of the first and the second method].

**Priority of security rights that are not effective against third parties**

**Unsecured creditors**

44. The law should provide that a secured creditor with a security right that is not effective against third parties has [towards third parties no right other than as an unsecured creditor] [priority over unsecured creditors unless the unsecured creditor has taken steps to reduce its claim to a judgement or the grantor has become insolvent].

**Secured creditors**

45. The law should provide that:

(a) A security right in an asset that is not effective against third parties is subordinate to a security right in the same asset that is effective against third parties, without regard to the order in which the security rights were created; and

(b) Priority among security rights that are not effective against third parties is determined by the order in which they were created.

**Priority of security rights that are effective against third parties**

**Unsecured creditors**

46. The law should provide that a security right that is effective against third parties has priority over the rights of unsecured creditors.

**Secured creditors**

47. The law should provide that:

(a) As between two security rights in the same encumbered asset that are effective against third parties, except as provided in recommendation [on priority of purchase-money security rights], 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. If one of the security rights is made effective against third parties by possession or control of the encumbered asset, the holder of that security right will have the burden of establishing when it obtained possession or control;

(b) Where a security right may be made effective against third parties by control, that security right has priority over a security right made effective against third parties by any other method;

(c) With respect to negotiable instruments, negotiable documents and money, a security right made effective against third parties by possession or control has priority over a security right made effective against third parties by registration.

**Judgement creditors**

48. The law should provide that, if, under applicable law, a judgement creditor, who has taken steps to enforce the judgement, acquires rights in assets of the judgement debtor, a security right that is effective against third parties has priority over the right of the judgement creditor that is registered after the security right has become effective against third parties, except with respect to amounts advanced by the secured creditor subsequent to a specified number of days after the date on which the judgement creditor registers a notice of its rights.

**Buyers of encumbered assets**

49. The law should provide that the right of a buyer of goods is subject to a security right that has become effective against third parties before the sale, unless the secured creditor authorized the sale. However, a buyer of inventory, who buys encumbered inventory in the ordinary course of business of the seller (and anyone whose rights to the encumbered inventory derive from that buyer), takes free of a security right that is effective against third parties in that inventory, even if such buyer has knowledge of the existence of the security right.

**Reclamation claims**

50. If the law provides that suppliers of goods have the right to reclaim the goods within a specified time after the buyer becomes insolvent, the law should also provide that such specified time is short, and that the right to reclaim the goods is subordinate to security rights in such goods granted by the buyer that are effective against third parties.

**Lessees**

51. The law should address the priority of a security right in a leased asset that is effective against third parties as against the rights of a lessee of such asset.

**Holders of promissory notes and negotiable documents**

52. The law should provide that the rights of a [person who by other law takes rights in a promissory note or negotiable document free of claims to it] [holder in due course of a promissory note or negotiable document] takes such asset free of a security right that is effective against third parties.

**Holders of rights in money**

53. The law should provide that the rights of a person, who gives value for, and has possession of, money, holds the money free of a security right in the money that is made effective against third parties only by registration.

**Statutory (preferential) creditors**

54. The law should limit, both in number and amount, preferential claims that have priority over security rights that are effective against third parties, and to the extent preferential claims exist, they should be described in the law in a clear and specific way.

### **Holders of rights in assets for improving and storing the assets**

55. If applicable law gives rights equivalent to security rights to a creditor who has added value to goods (e.g. by repairing them) or preserved the value of goods (e.g. by storing them), such rights should be limited to the goods whose value has been improved or preserved that are in the possession of such creditor, and should have priority over pre-existing security rights in the goods that are effective against third parties only to the extent that the value added by the improvement or preservation directly benefits the holders of the pre-existing security rights.

### **Creditors in insolvency proceedings**

56. The law should provide that a secured creditor's priority should continue unimpaired in an insolvency proceeding of the grantor, subject to applicable provisions of the insolvency laws pertaining to preferential claims and avoidance actions.

### **Subordination agreements**

57. The law should recognize agreements that alter the priority of security rights, provided that they affect only the persons who actually consent to such alterations. Such agreements should be binding on such persons even in the case of the insolvency of the grantor of the security rights.

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