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Draft legislative guide on secured transactions

Report of the Secretary-General

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XII. Acquisition financing devices

A. General remarks

1. Introduction

1. A retention-of-title seller, by extending credit terms to its buyer, is financing the buyer's acquisition of the goods (equipment or inventory) sold by the seller to the buyer. However, the retention-of-title seller is just one of several financiers that can finance a person's acquisition of goods. Specifically, a lender may provide credit to the buyer for the purpose of enabling the buyer to acquire the goods from the seller. In addition, a lessor who leases goods to its lessee on terms economically equivalent to those of a sale is likewise providing credit to enable the person to acquire the goods.

2. One of the key questions that a State considering law reform in the field of secured transactions must face is how to treat transactions that fulfil the economic function of secured transactions but which are effectuated through devices in which a seller or lessor retains title to goods until full payment, after which time title to goods is transferred to the buyer or lessee. The answer to this question depends on whether a State wishes to follow: (i) a unitary and functional approach under which transactions performing security functions are treated in essentially the same way (either under separate but substantively identical rules or integrated in the same set of rules as part of the secured transactions law); or (ii) an approach treating transactions on the basis of their form (the label applied by the parties) and not of their real function. This policy decision is bound to affect the rights of third parties (in and outside insolvency proceedings) and, as result, the availability and the cost of credit.

3. The Guide recommends a unitary and functional approach (see Chapter III. Basic approaches to security, Recommendations 6 and 7 in A/CN.9/WG.VI/WP.16). Such an approach promotes competition among credit providers and thus is more likely to increase the availability of credit at lower cost than an approach in which transactions performing security functions are treated substantially differently. An additional advantage to this approach is that it better enables policy decisions to be made transparently and on efficiency grounds. In line with this unitary and functional approach, this chapter suggests that acquisition financing transactions should be addressed, whether in the secured transactions law or in separate but substantively identical rules, regardless of the form of the transaction as a retention-of-title arrangement, secured transaction or financial lease arrangement.

4. This is not to say that a separate retention-of-title regime, with its own different rules, does not work well in a particular State when looked at in isolation. Rather, the question is whether, given the other recommendations in this Guide for an efficient, modern system providing for non-possessory security rights, purchase-money security rights and notice filing in a secured transactions registry, it makes sense for this Guide also to recommend a separate retention-of-title regime, with its own rules distinct from those in the secured transactions regime. This chapter takes the position that it does not.

5. This chapter discusses in part A.2 the commercial background, in part A.3 the various approaches taken in legal systems with respect to acquisition finance, in

part A.4 the creation of such devices as between the parties, in part A.5 the effectiveness of such devices as against third parties, in part A.6 priority as against competing claimants, in part A.7 enforcement, in part A.8 insolvency, in part A.9 conflict of laws and in part A.10 transition issues. Part B includes recommendations to the legislature considering law reform in the field of secured transactions.[1]

2. Commercial background

6. There are a number of different ways for a buyer to finance the acquisition of goods. First, a buyer might simply borrow the purchase price from a third party on an unsecured basis. This method is simple, but the buyer's credit rating or reputation might limit availability of such credit or make the cost of such credit prohibitively high. Second, the seller could agree to sell the goods to the buyer on terms (without security) that allow the buyer to make payment (perhaps in instalments) after the completion of the sale. This method, of course, is not really different than third-party finance except that the risk of non-payment is now on the seller rather than on a third-party financier. Many sellers are unwilling to bear such an unsecured risk. As a result, for many buyers, as a practical matter it is necessary for them to give some form of security in order to acquire goods on credit. While the property subject to a security right could be other property of the buyer, typically the most obvious source of security, and frequently the only source of security, is the acquired goods themselves. Utilizing such goods as security can be effectuated by formally granting a security right in the goods to a third-party financier or to the seller, or by use of a mechanism, which, although not in the form of a security right, is its economic equivalent. Two such mechanisms are the financial lease and retention of title (or, as it is sometimes known, "conditional sale", although it is not the sale that is conditional but rather the passing of ownership).

Retention of title and "conditional sales"

7. A supplier of inventory or equipment may wish to meet its customer's need for credit by supplying the goods to the customer directly or to a finance house or other lender who may then sell the goods on a "conditional sale" to the buyer. Under the "conditional sale", title to the goods sold is reserved by the seller until the purchase price has been paid in full or the buyer has complied with any other conditions prescribed in the sale agreement. In other words, the agreement by the seller to postpone full payment is protected by delaying the passing of title to the goods to the buyer. Such simple retention-of-title arrangements may, in some jurisdictions, be varied through certain clauses, including: "all monies" or "current account" clauses, in which the seller retains title until all debts owing from the buyer to the seller have been discharged (and not just those arising from the particular contract of sale); and proceeds and products clauses, in which the seller's title is extended to, or the seller is deemed to have a security right in, the proceeds and the products of the assets in

[1] In Chapter I. Introduction, "purchase-money security right" is defined as including retention-of-title devices (see A/CN.9/WG.VI/WP.11/Add.1, para. 17 (b)). However, in this chapter reference is made to the terms "retention of title" (seller and buyer) and its equivalents, such as a "purchase-money security right" (secured creditor and grantor) and a "financial lease" (financial lessor and lessee), to make the point that they should be treated in the same way. [*Note to the Working Group: The Working Group may wish to consider whether the term "acquisition security right" might be preferable*.]

which the seller retained title (see A/CN.9/WG.VI/WP.9/Add.1, paras.35-45). Often, however, the applicable law limits the retained ownership only to the goods sold, and only so long as they remain in their original condition (i.e. unaltered by the manufacturing process), or only to secure the sale price of those goods, or both.

Finance leases and hire-purchase transactions

8. A supplier may also use the concept of a lease to sell goods to a buyer. For example, a supplier of equipment may lease a piece of equipment to a buyer who takes possession of the equipment and pays for it in instalments. The supplier reserves title to the equipment as security for the payment of instalments as they fall due. Hire-purchase transactions are based on a similar principle. A typical leasing transaction would commence with the lessee (buyer) selecting the equipment from the supplier (seller) of the equipment. The lessee would then apply to a leasing company (usually a financial institution or an affiliate of one) to purchase the equipment from the supplier and to lease it to the lessee. Generally, the lease comprises the useful life of the equipment and the lessee has the option to purchase the equipment at the end of the lease period for a nominal sum. Alternatively, the lease period is for less than the useful life of the equipment, but the lessee at the end of the lease period has the option to purchase the equipment at a bargain price. Although the transaction is referred to as a finance lease, the reality is that the lessee is paying the purchase price for the equipment in instalments, while the lessor remains the owner until full payment is made. Lease periods may range from a few months to a several years and items leased may range from high-value equipment, such as aircraft, to lower-value equipment, such as computers. Often, leasing arrangements are tailored to the lessees' unique cash-flow requirements and other needs.

3. Approaches to the financing of the acquisition of goods

9. As an element of property (or sales) law, the technique of title retention is known in most legal systems, both civil law and common law. Its conditions and effects, however, vary widely. Many of these differences are products of history (often originating from a need to fill gaps or avoid inflexible rules), rather than the results of contemporary economic analysis. Indeed, in many countries, existing business practices do not support continuation of the legal status quo, as those practices reflect neither legislative policy nor the free choice of the parties but rather are simply the product of the inflexibility of existing legal rules and the absence of legislative intervention, leaving the law to be developed by courts lacking the institutional capability to modernize the legal structure.

10. In legal systems that do not follow a unitary and functional approach in their secured transactions legislation, different statutes or judge-made rules deal with different types of secured transactions or transactions that perform security functions while they bear different names. In some of those systems, retention of title and economically equivalent devices, often developed by practice and courts in the absence of legislation, are the main or the only devices that provide security while the debtor remains in possession of the assets offered as security ("non-possessory security rights" from the point of view of the creditor). This approach is sometimes based on a policy decision to protect small- and medium-size suppliers of goods on credit over large financing institutions in view of the importance of

small- and medium-size businesses (manufacturers and distributors) for the economy and the dominant position of financing institutions in credit markets. In those countries, a number of assumptions are made to justify the use of retention-of-title and economically equivalent devices, including that: suppliers have an interest in providing credit at low rates to increase the volume of their sales; the cost of such credit is affordable to the extent that suppliers do not charge interest and, as a result of competition among suppliers, competitive sales prices are offered to buyers; and that buyers may benefit from the competition between supplier credit and bank credit as retention of title is available only to suppliers while banks can obtain it only through an assignment of the claim for the purchase price.

11. A State considering law reform in the field of secured transactions, however, needs to evaluate these assumptions carefully. The fact that a supplier of goods sells goods to a buyer under a retention-of-title arrangement, does not necessarily mean that the seller's credit terms come at no cost to the buyer. The supplier itself has a cost of obtaining funds in order to extend credit terms to the buyer. The supplier's cost of obtaining the funds is embedded in the price of the goods to the buyer. In addition, a State interested in promoting the manufacture and supply of goods does not necessarily have to favour suppliers of goods over parties financing the acquisition of goods. In the same way that competition among suppliers of goods drives down the prices of goods, competition among suppliers of credit drives down the cost of credit. Fostering competition among all suppliers of credit will not only result in credit being available to the buyer at the cheapest rates for the acquisition of goods but also will open up other sources of credit which enable buyers to make payments to sellers for goods supplied. This is especially important for States seeking to expand sources of credit. Additional sources of payment available to buyers will in themselves encourage the manufacture and supply of goods by reason of the flexibility afforded to sellers to sell and receive payment for the goods without the necessity of themselves providing financing to the buyers.

12. Moreover, financiers for the acquisition of goods do not consist only of sellers of goods and of lenders providing working capital financing to the grantor and holding a security right in existing and future assets of the grantor. Although this may be the case currently in some States, that situation may be the product of old legal structures and is not economically inevitable. The legal rules for the State's secured transactions regime should not create legal barriers for other financiers to emerge to extend credit for the buyer to acquire the goods. The legal rules should allow for the possibility not only for retention-of-title sellers and pre-existing secured creditors to compete for the right to provide financing to buyers (grantors and lessees) but also for other banks, finance companies and financial lessors to do so.

13. In some of the legal systems that do not follow a unitary and functional approach, some of the expanded types of retention-of-title clauses are recognized, such as proceeds clauses (often referred to as "extended retention of title"). However, in the absence of specific tracing rules, in these legal systems title actually extends to proceeds only if they are readily identifiable. In these legal systems, retention of title is available only to lenders that finance the seller taking as security the seller's purchase-money claim with the retentions of title. In some of those systems that recognise a buyer's right expectancy in the goods, the buyer may create a lower-ranking security right in the goods in favour of another creditor. In

other legal systems that do not follow a unitary and functional approach, only the simple retention of title is treated as a title device, while more complex retention-of-title clauses, such as all-sums clauses, or proceeds or products clauses, are either not recognized or are treated as security rights.

14. In yet other legal systems with functional secured transactions legislation, acquisition financing transactions are either treated under separate but substantively identical rules or are integrated into the same set of rules comprising the secured transactions laws. If acquisition financing transactions are addressed in separate statutes or in a body of judicially developed law, the various rules and their consequences need to be coordinated with the secured transactions rules in those States. To avoid the risk of imperfect coordination, some of those legal systems integrate acquisition financing transactions into the same rules that govern security rights and treat them all as secured transactions. Both approaches are based on a policy decision to treat all transactions performing security functions equally and to create equal opportunities for all credit providers, on the assumption that this will enhance competition among credit providers and competition will increase the amount of credit available and will drive down its cost.

15. In those jurisdictions, retention of title is available as a so called "purchase-money security right" (see definition in Chapter I. Introduction, in A/CN.9/WG.VI/WP.11/Add.1, para. 17 (b)). The purchase-money security right: (i) is available not only to suppliers but also to other providers of credit, including lenders and lessors; (ii) the purchase-money creditor is given a security right, regardless, for secured transactions purposes, of whether that creditor retains title to the goods; (iii) the buyer may offer a lower-ranking security right in the same goods to other creditors and is thus able to utilize the full value of its assets to obtain credit, thereby enhancing mobilization of capital within the economy; (iv) the purchase-money creditor has to register a notice of its security right in a secured transactions registry to establish priority over competing claimants and to provide third parties with a way of being informed that a security right is claimed by another creditor in the same goods; (v) once a notice of the security right is filed in the secured transactions registry the security right is effective against third parties; (vi) if the notice is filed within a short period of time after delivery of the goods to the buyer, the purchase-money security right has priority over a holder of a judgement right or an insolvency administrator of the buyer between the time of the delivery of the goods to the buyer and the filing of the notice; (vii) if the goods are equipment, and notice is filed within a short period of time after delivery of the equipment to the buyer, the purchase-money security right has priority over the security right of a pre-existing secured creditor with a security right in future equipment of the buyer; (viii) if the goods are inventory, and, before the inventory is delivered to the buyer, the purchase-money creditor files the notice in the secured transactions registry and also notifies a pre-existing secured creditor with a security right in future inventory of the buyer, for which a notice has been filed in the secured transactions registry, that the purchase-money creditor is claiming a higher-ranking purchase-money security right in the inventory, the purchase-money security right has priority over the security right of the pre-existing secured creditor; and (ix) the purchase-money creditor seller may enforce its rights, within or outside insolvency proceedings, in the same way as any other secured creditor.

16. The modern trend in law reform in the area of secured transactions, particularly in States that need to introduce or enhance a credit economy, is to follow a unitary and functional approach and thus to deal in a comprehensive and consistent way with all transactions that perform security functions, irrespective of their name or form. The same trend prevails at the international level as well. For example: the Convention on International Interests in Mobile Equipment subjects retention of title and financial leases to separate but substantively identical rules and, most importantly, extends the international registry contemplated by the Convention beyond security rights to retention of title in favour of sellers and to leasing arrangements; the United Nations Assignment Convention applies the same rules to: (i) security assignments; (ii) outright assignments for security purposes; and (iii) even pure outright assignments (article 2), avoiding drawing a distinction between security and title devices that would inadvertently lead to uncertainty and litigation (and, most importantly, article 22 of the Convention covers various priority conflicts, including a conflict between an assignee of receivables and a creditor of the assignor with a retention of title in goods extending to the receivables from the sale of the goods). The same approach is followed in the EBRD Model Law on Secured Transactions, the Inter-American Law on Secured Transactions and the Asian Development Bank Guide to Movables Registries.

17. The specific terminology used, and whether acquisition finance devices are recharacterized as security rights or are treated like secured transactions in separate but identical rules, is not so important (although the former approach may be preferable to avoid the problem of coordination among the various statutes). What is important is that essentially the same rules apply to all transactions that perform security functions. It makes no sense for a secured transactions regime to adopt substantially different rules for providers of purchase-money financing depending upon the form of the transaction. If retention-of-title sellers, purchase-money lenders and financial lessors are subject to substantially different rules, then competition among them will not be based on price alone. Rather, the differing rules will create advantages for some credit providers over others, impairing pure price competition.

4. Creation as between the parties

18. Legal systems that treat retention of title as a non-security device differ widely with respect to the requirements for its creation. In many of those systems, the subject of creation is usually governed by the general contract law. As a result, retention of title, which normally arises from a clause in a sales contract, may be concluded even orally or by reference to correspondence, a purchase order or an invoice with printed general terms and conditions. These documents may not bear the signature of the buyer but may be implicitly accepted by the buyer through the acceptance of delivery of the goods and payment of part of their purchase price as indicated, for example, in the purchase order or invoice.

19. In some of those legal systems, only the seller may retain title, while other lenders may obtain the retention of title only if they receive an assignment of the outstanding balance of the purchase price from the lender. Lenders in the context of financial leases, hire-purchase and related transactions may, however, retain title in the context of those transactions.

20. In other legal systems, a writing (even minimal), a date certain, notarization or even registration may be required for a retention-of-title clause to be effective. In some of those systems, if goods subject to retention of title are then commingled with other goods, the retention of title is extinguished, while in a few other systems the retention of title is preserved as long as similar goods are found in the hands of the buyer, with the seller being deemed to hold title to such similar goods. In some legal systems, retention of title is preserved even if the goods are processed into a new product, while in other systems retention of title cannot be extended to new products.

21. In legal systems with a unitary and functional secured transactions law, the financing of the acquisition of goods is treated as a special category of secured financing, either in parallel but substantially identical rules to secured transactions rules or integrated in the secured transactions legislation. Such financing may be provided by the seller or by any other person and the form requirements are the same as those that relate to other secured transactions (e.g. a written and signed agreement identifying the parties and reasonably describing the assets sold and their price).

22. The difference among the legal systems described above rarely lies in a significant way in the requirement of a writing, since most of them would accept correspondence, an invoice, a purchase order or the like with general terms and conditions, whether they are in paper or electronic form. The difference seems to lie more in the requirement of a signature which may not be necessary as long as the retention-of-title seller, purchase-money lender or financial lessor is able to demonstrate by other evidence that the terms of the writing have been accepted by the buyer or financial lessee. Such evidence could consist merely of the buyer's or financial lessee's acquisition and use of the goods without protest after having received the writing. Thus, these minimal formal requirements are not burdensome. Also, because so many transactions for the purchase of goods are in fact well documented for other reasons, this issue rarely arises.

5. Effectiveness against third parties

23. In most jurisdictions that treat retention-of-title devices as a non-security device, with very few exceptions, retention-of-title devices are not subject to registration. In addition, even where registration is required, no distinction is drawn between creation of a property right as between the parties and its effectiveness as against third parties. To the contrary, upon their creation, property rights are effective as against all parties. The creditor retaining title has full ownership rights and any other creditor has nothing even if it provided credit to the buyer and the value of the buyer's assets subject to retention of title is higher than the amount of its obligations owing to the seller (with the exception of those legal systems in which the buyer may encumber its expectancy right). These legal systems either prevent or make it difficult for borrowers to use the full value of their movable assets subject to retention-of-title rights by providing a non-possessory security right in the same assets to several creditors or a system to rank those creditors in terms of priority for payment (although such a system exists with respect to immovable property where there can be multiple mortgagees with priority based on time of registration).

24. In jurisdictions that follow a unitary and functional approach, retention of title and its economic equivalents are subject to registration of a notice in the secured transactions registry in the same way as any other secured transaction. The registration of the notice does not create the security right but rather serves as a basis for establishing priority and provides a notice to third parties that such a right might exist. Registration efficiently promotes credit market competition by, inter alia, providing information in the registry that is available to all creditors. In the context of a function-based system, registration enhances the quality of opportunity among suppliers. The system enables financiers to better assess their risks and promotes certainty in the financing of the acquisition of goods. If creditors were not able to rely upon the security rights registry to indicate the possible existence of pre-existing retention-of-title arrangements, the integrity and the usefulness of the registry itself would be undermined. The creditor's uncertainty as to the priority of its security right, given its inability to rely on the registry, would reduce the availability of credit or result in an increase in the cost of credit, even in situations where no retention-of-title arrangement exists with respect to the relevant goods.

Effectiveness of purchase-money transactions relating to equipment or inventory as against third parties

25. In some jurisdictions, the general rules of third-party effectiveness applicable to non-purchase-money secured transactions apply to purchase-money secured transactions. However, for priority purposes with respect to certain competing claimants, there are certain special rules as discussed below.

Grace period for the registration of purchase-money security rights

26. The registration process is enhanced by permitting a short specified period ("grace period") within which a retention-of-title right may be registered (e.g. 20 or 30 days following delivery of the goods to the grantor). The use of the grace period has the advantage that it permits delivery of the goods without delay until registration is made. If the notice is registered within the grace period, the purchase money security right has priority over a judgement right in the goods or the rights of creditors in the insolvency of the grantor (buyer), acquired during the grace period.

Exceptions to registration

27. In some legal systems, purchase-money lending transactions with respect to consumer goods (i.e. goods bought for the buyer's personal, household or family purposes) are generally exempted from the registration requirement. This means that the purchase-money seller of consumer goods is not burdened with a requirement to register. Such transactions become effective against third parties as of the time they are made. In any case, the need to warn potential third-party financiers is less acute (unless consumers resell those goods), in particular in the case of transactions relating to low-value consumer goods. In other legal systems, only low-value consumer transactions are exempted from registration (e.g. consumer transactions up to a maximum of Euro 3,000.00, or their equivalent that, are subject to the jurisdiction of small-claim courts), while the significant car market involving credit to consumers is served by a system requiring, not registration in the secured transactions registry, but a notice on a title certificate. Even if business and consumer transactions relating to low-value assets are excepted from registration,

the exception does not in any event apply to low-value inventory transactions (individual items of low-value inventory may have a large value when all low-value inventory is pooled).

28. If a grace period were adopted for registering the notice of a purchase-money lending transaction relating to equipment in the secured transactions registry, that grace period may in itself serve as an exemption for short-term transactions completed (i.e. fully paid) within the grace period because, as a practical matter, the purchase-money lender would not have to register before the expiry of that period. However, as for equipment-related purchase-money lending transactions with longer repayment periods, and for short-term inventory-related purchase-money lending transactions in general, an exemption may not be necessary if the purchase-money lender could register a single notice in the secured transactions registry for a series of short-term transactions occurring over a longer period of time (e.g. five years).

6. Priority over competing claimants

29. In legal systems that treat retention-of-title transactions as non-security devices, the retention-of-title seller effectively prevails with respect to the goods sold over all other competing claimants (except bona fide purchasers). In legal systems with unitary and functional secured transactions systems, this result is possible, provided that the retention-of-title seller, who is treated in the same way as the purchase-money lender or the financial lessor, registers a notice in the secured transactions registry within a short grace period and, in the case of inventory, takes certain steps discussed below to obtain priority over a pre-existing secured creditor with a security right in future inventory of the buyer. Thus, title retention outside of the secured transactions regime is not essential to achieve the desired priority results.

Priority of purchase-money security rights over pre-existing security rights in future equipment

30. In an effort to support the provision of new credit for the acquisition of additional goods which stimulates the production and trade of goods, it is important that special priority rules apply to conflicts of priority with pre-existing non-purchase-money secured creditors holding rights in future assets of the grantor. Upon registration with respect to equipment, within a certain period of time after delivery of the goods to the grantor, the purchase-money security right is given priority over pre-existing security rights in future equipment of the grantor. This means that, as long as a notice is registered about it in the secured transactions registry within the grace period, the purchase-money security right in new equipment obtains priority over pre-existing security rights in future equipment of the grantor (often referred to as "super-priority" as it overcomes the general rule based on priority in time of registration).

Priority of purchase-money security rights over pre-existing security rights in future inventory

31. Where the additional goods acquired by the grantor are inventory, in order for the purchase-money security right to have priority over a non-purchase-money security right in future inventory, the registration of a notice in the secured transactions registry must be made prior to the delivery of the additional inventory

to the grantor. In addition, in some jurisdictions, pre-existing inventory financiers on record must be directly notified that a higher-ranking purchase-money security right is being claimed in the additional inventory. The reason for requiring such notification of pre-existing inventory financiers on record is that inventory financiers typically extend credit in reliance upon a pool of existing or future inventory on a short periodic and perhaps even daily basis. The pool of inventory may be constantly changing as some inventory is sold and new inventory is manufactured or acquired (with the grantor presenting invoices or certifications as the basis for obtaining each new advance of inventory credit). In these circumstances, it would be inefficient for the inventory financier to be required to search the secured transactions registry each time before advancing credit in reliance upon a pool of ever-changing inventory. In addition, if the purchase-money creditor were not required to notify the pre-existing inventory financiers and they did not otherwise discover in time the notice registered in the secured transactions registry with respect to the acquisition of new inventory, the new advances that the pre-existing inventory financiers would make could be used by the grantor for other purposes (which would result in double financing of the same inventory).

32. To avoid placing an undue burden on purchase-money financiers, a single, general notification to pre-existing inventory financiers on record may be effective for all shipments to the same buyer occurring during a significant period of time (e.g. five years or the same period that registration lasts to make a security right effective against third parties). This would means that, once notification was given to pre-existing inventory financiers on record, it would not be necessary to give a new notification within the given time period for each of the multiple inventory transactions between the purchase-money lender and the party acquiring the inventory.

Cross-collateralization

33. In addition, in jurisdictions with a unitary and functional approach, the super-priority of purchase-money security rights is not impaired by cross-collateralization. This means that, if the purchase-money creditor provides additional credit to the grantor secured by a security right in additional equipment or inventory, the super-priority is still effective for the security right to the extent that it secures payment of the purchase price or obligations incurred to pay the purchase price of the equipment or inventory. Similarly, if the purchase-money lender obtains a security right in other assets of the grantor to secure the purchase price or obligations incurred to pay the purchase price of equipment or inventory, the super-priority of the financier in the equipment or inventory remains effective (although the super-priority does not extend to other assets that themselves were not financed by the purchase-money creditor).

Super-priority in proceeds

34. In some jurisdictions with a unitary and functional approach, the super-priority extends only to the goods the acquisition of which is financed, while in other jurisdictions it extends to their proceeds and products as well, at least in the case of transactions relating to equipment.

35. As equipment is not usually acquired by the grantor with a view to resale, there is little concern if the super-priority of a purchase-money security right in

equipment is extended to the proceeds of the equipment. If the equipment, perhaps because it is obsolescent or no longer needed by the grantor, is later to be sold or otherwise disposed of by the grantor, the secured creditor will often be approached by the grantor for a release of the security right to enable the grantor to dispose of the equipment free of the security right. That is because, without that release, the disposition would be subject to the security right, and it would be unlikely that a buyer or other transferee would pay full value to acquire the equipment subject to the security right. In exchange for the release, the secured creditor will typically control the payment of the proceeds. For example, the secured creditor might require that the proceeds of the disposition be paid directly to the secured creditor for application to the secured obligations. Under these circumstances, it is unlikely that another creditor, in extending credit to the grantor, will be relying upon a superior security right in an encumbered asset that is proceeds of the disposition of the equipment.

36. However, the situation is different with inventory because its proceeds usually consist of receivables. It will often be the case that a pre-existing secured creditor, in extending working capital credit to the grantor, will be advancing credit to the grantor on short periodic and perhaps even daily basis in reliance upon a superior security right in an ever-changing pool of existing and future receivables as original encumbered assets. It may not be possible or practical for the grantor to segregate the receivables that are the proceeds of the purchase-money inventory from other receivables being financed by the pre-existing secured creditor. Even if it were possible or practical for the grantor to do so, it may not be possible for the grantor to segregate the purchase-money inventory proceeds promptly. And, even if it were possible or practical for the grantor to segregate the purchase-money inventory proceeds promptly, it would have to do so in a way that was transparent to both financiers and which minimized monitoring by both financiers.

37. Without such a prompt segregation that is transparent to both financiers and which minimizes monitoring, there would be a significant risk that the pre-existing secured creditor extending credit against receivables would mistakenly assume that it had a higher-ranking security right in all of the grantor’s receivables. There is likewise a risk of a dispute between the pre-existing secured creditor and the retention-of-title seller, purchase-money lender or financial lessor as to which financier has a priority right in which proceeds. All of those risks and any concomitant monitoring costs may result in the withholding of credit or charging for the credit at a higher cost.

38. Of course, if the priority of the purchase-money security right in the inventory does not extend to the receivables proceeds, the inventory purchase-money secured creditor may itself withhold credit or offer credit only at higher cost. However, that risk may be ameliorated in a significant respect. First, if the priority of the purchase-money security right in the inventory does not extend to the receivables proceeds, a pre-existing secured creditor with a prior security right in future receivables of the grantor will be more likely to extend credit to the grantor in reliance upon its higher-ranking security right in the receivables to enable the grantor to pay for the purchase-money inventory acquired by the grantor. The amount of the advance by the pre-existing secured creditor should be sufficient for the grantor to pay the purchase price to the grantor of the purchase-money inventory. This is because usually advance rates against receivables are much higher

than those against inventory and because the amount of the receivables reflects a resale price for the purchase of the inventory well in excess of the cost of the inventory to the seller. Thus, there is a greater likelihood that the purchase-money obligation will be paid on a timely basis. Such a result would be both efficient and convenient for the parties to the transaction.

7. Enforcement

39. In some legal systems where retention of title is treated a non-security device, the seller may on default of the buyer terminate the sales agreement and demand return of the goods as an owner. In that event, the seller is required to refund any portion of the price paid, after deducting the rental value of the goods while in the possession of the buyer, the amount by which the value of goods has decreased as a result of their use by the buyer or damages determined under a similar formula. A seller who has priority over competing claimants is not obliged to account to the buyer for any of the profits made on any subsequent resale of the goods by the seller but, at the same time, has no claim against the buyer for any deficiency beyond any damages resulting from the buyer's breach of the original sales contract. In some of those legal systems, in some instances courts have ruled that there is an implied term in retention-of-title arrangements that the seller cannot repossess more of the goods than is necessary to repay the outstanding balance of the purchase price.

40. In other legal systems where retention of title is treated as a security device, the purchase-money lender may repossess the goods as would any other secured creditor. The secured creditor has to return to the grantor any surplus on the resale of the goods and has an unsecured claim for any deficiency. Thus, the buyer and its other creditors have the same protections regardless of the form of the transaction.

41. Arguably, either remedial scheme might be appropriate for a State to consider so long as the scheme applied equally to retention-of-title sellers, purchase-money secured creditors and financial lessors. However, the secured credit scheme might be preferable as a policy matter as it would provide the creditor with a deficiency claim, which usually will be more valuable to the seller than a surplus claim. Almost invariably, except in the rare case when only a conservatively small portion of the purchase price is being financed, the likelihood of there being a surplus on enforcement to be retained by the creditor is not as high as the likelihood that there will be a deficiency.

42. A rule that would deny a deficiency claim to a purchase-money secured creditor would encourage the creditor to finance a smaller portion of the purchase price of the goods so as to minimize the amount of any lost deficiency claim. The result would be that grantors without sufficient funds to pay the balance of the purchase price will be denied the purchase-money credit or will have to obtain the purchase-money credit at a higher cost. This result could discourage the manufacture, supply and financing of the acquisition of goods.

8. Insolvency

43. Generally, but not universally, in legal systems that treat retention of title as a non-security device, a sales contract with a retention-of-title clause is treated in the insolvency of the buyer not as a security right but instead under the rules relating to partly performed contracts (or, in other words, as a title device). In legal systems

that recognize purchase-money security rights in separate but essentially identical rules or integrated into their secured transactions law, a purchase-money security right is treated in the grantor's insolvency in the same way as a non-purchase-money security right (with recognition given to any super-priority status accorded to the purchase-money security right under non-insolvency law).

44. Where retention of title is treated as a partly performed contract (or title device), the insolvency administrator has the right, within a prescribed time and if willing and able to do so, to perform the contract, pay the outstanding balance of the price and retain the goods in the estate. Alternatively, in some cases, the insolvency administrator can sell the contract, together with the right to use the goods, to a third party; or the insolvency administrator can reject the contract, return the goods and claim the return of the part of the purchase price paid by the buyer. But if the goods are critical to the success of the buyer's reorganization, only the first option (performance of the contract as agreed) would in practice be available to the insolvency administrator. The need for the insolvency administrator to perform the contract as agreed (and keep, for example, useful equipment, although its value is less than their price) will usually result in other assets of the insolvency estate being used to satisfy that performance rather than being used to fund other aspects of the reorganization of the grantor. In such a case, the diversion of other assets of the insolvency estate to enable the insolvency administrator to perform the contract may be especially of concern where the value of the goods is less than the amount of the price to be paid.

45. In contrast, where the purchase-money security right is treated in the same way as an ordinary (non-purchase-money) security right, typically: (i) the insolvency administrator could use, sell or lease the goods so long as it gives substitute assets to the secured creditor or the value of the secured creditor's right in the goods is otherwise protected; (ii) any portion of the secured obligations in excess of the value of the secured creditor's right in the goods is treated as a general unsecured claim; and (iii) in the grantor's reorganization, the secured creditor's claim, up to the value of the security right, can be restructured (as is the case with other non-purchase money security rights) with a different maturity, payment schedule, interest rate and the like.

46. If retention of title and its functional equivalents purchase-money security rights and financial leases are treated as partly performed contracts (or title devices), the retention-of-title seller (the purchase-money lender and the financial lessor) will have stronger rights at the expense of other creditors of the insolvency proceedings. The exercise of the stronger rights might result in some reorganizations not being successful, with possible loss of jobs and with other creditors of the insolvency estate not obtaining as much of a recovery on their claims. Thus, a State considering the treatment of retention of title, purchase-money security rights, financial leases and the like in insolvency proceedings should consider whether the State's policy of encouraging the manufacture, supply and financing of equipment or inventory through the strengthening of the rights of retention-of-title sellers, purchase-money secured creditors or financial lessors outweighs or is subordinate to the State's policy favouring reorganization proceedings.

9. Conflict of laws

47. Whether retention of title is treated as a security device or not, the law applicable to its creation, effectiveness and priority should be the law of the State in which the goods are located. Different rules should apply to mobile goods, goods in transit and goods intended for export. In addition, a rule is needed to ensure the cross-border recognition of those rights (see Chapter X. Conflict of laws in A.CN.9/WG.VI/WP.16/Add.1).[2]

10. Transition

48. The rules regarding treatment of retention of title as a security device will be a significant change in legal systems that do not have a unitary and functional secured transactions law. Chapter XI of the Guide (see A/CN.9/WG.VI/WP.9/Add.8) discusses transition issues so as to allow parties to prepare for the application of the new law and to avoid abrupt changes to the rights of parties under transactions existing before enactment of the new law. With respect to retention-of-title devices, this result could be achieved if, consistent with the transition rules applicable to non-purchase money transactions, the pre-effective date effectiveness against third parties and priority of retention-of-title devices are preserved so long as an appropriate notice is registered in the secured transactions registry. Alternatively, the law could provide an effective date that would be sufficiently long so as to cover the life span of most retention-of-title arrangements existing at the time of the enactment of the law (e.g. 3 to 5 years).

[*Note to the Working Group: Part B. Recommendations is contained in document A/CN.9/WG.VI/WP.17/Add.1.*]

[2] Article 4 of EC Directive 35/2000 of 29 June 2000 on combating late payment in commercial transactions obliges member States to recognize title retention created in another member State in accordance with the rules of private international law. It is widely acknowledged that the applicable law is the *lex rei sitae*. Articles 5 (on *in rem* rights) and 7 (on reservation of title) of EC Regulation 1346/2000 of 29 May 2000 on insolvency proceedings are also based on the *lex rei sitae*.