United Nations A/CN.9/WG.VI/WP.18

General Assembly

Distr.: Limited
1 December 2004*

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
Seventh session
New York, 24-28 January 2005

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Contents

* 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.

V.04-59521 (E) 211204 221204

XVI. Security rights in bank accounts

A. General remarks

1. Introduction

1. Security rights in a depositor's rights in a bank account play an important role in a number of credit transactions. A secured transactions regime which recognizes security rights in bank accounts and provides clear rules relating to the creation, effectiveness against third parties, priority and enforcement of security rights in bank accounts will encourage the extension of credit at lower rates in those transactions where a security right in a bank account is a necessary or significant part of the decision of the creditor to extend credit.

2. This Chapter addresses issues arising in the context of security rights in cash in bank accounts (expressing a claim of the account holder against the depositary bank for payment of money). It does not address security rights in securities accounts.

3. Part A of this paper discusses a variety of issues relating to security rights in bank accounts. Part B of this paper sets out proposed recommendations. More specifically, Part A.2 provides some background of the types of credit transactions in which a security right in a bank account might be an important element and which would be facilitated by a secured transactions law that recognized security rights in bank accounts. With that background, Part A.3 addresses the meaning of the term "bank account". In Part A.4, this paper then discusses issues relating to the creation of a security right in a bank account; in Part A.5, it discusses the effectiveness of a security right in a bank account against third parties; and in Part A.6, it discusses the priority of the security right in the bank account against competing claimants. In Part A.7, the paper addresses issues involving the enforcement of a security right in a bank account, and in Part A.8, it addresses issues relating to the rights and duties of the depositary bank. After discussing insolvency law in Part A.9 and conflict of laws issues in Part A.10, this paper makes several concluding remarks in Part A.11, before setting forth the proposed recommendations in Part B.

2. Commercial background

4. A potential borrower's credit balance in a bank account may constitute a significant asset and, as with other property, should be available to serve as an asset in which a security right may be granted to facilitate the extension of credit. In States in which such a security right may be created, there are, in fact, a number of common credit transactions in which a security right in a bank account is an important element. Those transactions, which include, but are not limited to, trade finance, asset-based lending, real estate lending, project finance, securitization, derivative and securities lending transactions, would be facilitated by a secured transactions law that recognized security rights in bank accounts.

5. Some examples of transactions in which a security right in a bank account is the primary basis on which credit is granted include the following:

(a) A grantor may apply to a bank or other creditor for the creditor to issue or arrange for the issuance of a stand-by letter of credit, independent bank guarantee or surety bond in favour of a party with which the grantor has a contractual relationship, whether relating to the domestic or international purchase of tangible property, the performance of a construction contract or even the mere payment of a promissory note or other monetary obligation. In such a case, the grantor will have an obligation to reimburse the creditor for any amount paid by the creditor in respect of a draw under the stand-by letter of credit, independent bank guarantee or surety bond. To lower the risk of loss in the event that that the grantor does not fulfil its reimbursement obligation, the creditor may also require the grantor to secure that obligation by granting to the creditor a security right in a bank account of the grantor containing funds in an amount sufficient to fulfil the maximum reimbursement obligation should the creditor be required to pay the undrawn amount of the stand-by letter of credit, independent bank guarantee or surety bond;

(b) A security right in a bank account is often a key part of the structure of a derivatives or securities lending transaction. For example, a holder of securities may "lend" to a borrower counterparty securities which the lender counterparty owns with the agreement of the borrower counterparty to return to the lender counterparty those securities, or securities of the same type and quantity, on a date certain. The obligation of the borrower counterparty to the lender counterparty will often be secured by a security right in a bank account of the borrower counterparty in an amount at least equal to the value of the securities to be returned;

(c) Under some credit arrangements, a grantor is permitted to sell an encumbered asset, such as a piece of equipment or other fixed asset, for cash and deposit the cash proceeds in a bank account. For an agreed period of time (e.g. twelve months) thereafter the grantor is permitted to decide whether it wishes to use the funds in the bank account to purchase a new asset to become subject to a security right in favour of the secured creditor. If, at the end of the agreed period, the funds have not been used to purchase the new asset, the grantor must use the funds in the bank account to reduce the secured obligation. The secured creditor is typically provided a security right in the bank account during the period between the sale of the original encumbered asset and the use of the funds either to purchase the new asset or to reduce the secured obligation;

(d) A creditor might extend credit to a business that uses its revenues to pay its current expenses on a periodic basis before using the balance of the revenues to pay obligations owed to the creditor. The business may be a real estate project, such as a commercial building that leases space to tenants, or a power project, such as a power plant, which provides power to customers. The creditor may require, as a condition to extending the credit, that the grantor provide to the creditor a security right in the grantor's bank account to which the business's revenues are credited. The documentation for the financing of the commercial building or of the power project often provides a clause which creates a "waterfall" for the business revenues deposited into the bank account. Under the "waterfall" arrangement, applicable unless the grantor defaults, certain amounts are released from the bank account to pay budgeted expenses, with the balance of the funds being used to pay interest and principal on the loans advanced and to create reserves for future needs of the building or the project. The reserves themselves are often deposited into a separate bank account in which the creditor has a security right;

(e) In a structured finance transaction, a third party agent or trustee may be required to receive revenues from receivables purchased by a special purpose company from the originator of the receivables and to apply the revenues to obligations owed to investors after certain expenses are paid. The documentation for the structured finance transaction may contain a "waterfall" provision much like that described above for commercial building or project financings, but it is usually a simpler one since the special purpose company is not itself engaging in business operations. In any event, the agent or trustee will typically receive a security right in all bank accounts of the special purpose entity;

(f) A security right in a bank account may be of significance in an asset-based financing transaction, i.e. a credit transaction in which the secured creditor is looking to the encumbered assets in which its has a security right as its primary means of repayment. This is particularly the case when the encumbered assets are working capital assets, those that "turn over" and are transformed into cash in the ordinary course of the grantor's business. Inventory may be sold in the ordinary course of the grantor's business, creating receivables which are in turn reduced to payments deposited to a bank account. In order for the secured creditor to obtain a security right in the value of the encumbered assets for which it bargained with the grantor, the secured creditor will either desire to be paid immediately from the bank account or, alternatively, to obtain a security right in the bank account in replacement for the secured creditor's security right in the inventory sold or receivables collected;

(g) In States that recognize the concept of a security right continuing in proceeds of other encumbered assets and where the proceeds consist of cash deposited to a bank account, the secured creditor's proceeds interest, as a replacement for the secured creditor's security right in original encumbered assets, will often continue in the bank account itself to the extent that the proceeds may be identified to the credit balance of the bank account. In those States that do not recognize the concept of a security right continuing in proceeds of other encumbered assets, the secured creditor, if it wishes to obtain a security right in the proceeds which have replaced its original encumbered assets, will need to obtain a separate security right in the bank account to which the proceeds have been deposited.

3. The meaning of the term "bank account"

6. This paper uses the term "bank account" to mean an account with a bank into which funds are deposited by the bank's customer. The bank account might be a checking account or a time deposit or savings account. If the account is a savings account, it may or may not be evidenced by a savings book.

Bank account as a claim against the bank

7. A bank account is, in effect, a special type of receivable, i.e. a claim of the customer against the depositary bank for the money deposited in the bank by the customer. In that sense, the customer is the bank's creditor, the bank is the customer's debtor, and the credit balance is the amount of the claim. The notion that a bank account is a mere claim of the customer against the depositary bank may not be consistent with the colloquial perception of a bank account as a specific sum of money set aside in specie or otherwise by the bank for the benefit of the customer.

However, because banks deploy the pool of funds deposited by their customers by making loans and other investments with the funds, it is not possible for any one bank customer to identify its funds deposited to the bank account as constituting any particular cash at the bank, let alone any particular loan or investment by the bank. Accordingly, the characterization of the bank account as a mere claim is a more accurate characterization of a typical bank account transaction.

Ownership of the claim

8. Usually the bank's customer is both the legal and the beneficial owner of the bank account, i.e. the legal and beneficial holder of the monetary claim against the bank with respect to the bank account. However, in some cases the bank account may be held in legal title by the bank's customer acting as a trustee, escrow agent or other fiduciary for one or more third party beneficiaries.

What constitutes a "bank"

9. What type of legal entity constitutes a "bank" varies from State to State. In addition, the type of legal entity that may constitute a "bank" under a specific statute or rule of law of a particular State may be different than under other statutes and rules of law of that State, depending upon scope and purpose of the specific statute or rule of law. Nevertheless, the term would normally include any lending institution which accepts cash deposits from its customers.

The bank/customer relationship

10. The relationship between a bank customer and its bank pertaining to a bank account is usually governed by general law (although some States have specific statutes). These laws are generally not part of the State's secured transactions law.

Bank account distinguished from a negotiable instrument

11. A bank account should be distinguished from a negotiable instrument issued by a bank representing the bank's monetary obligation to its customer. Some banks issue notes or "certificates of deposit" which meet the requirements for a negotiable instrument under applicable law.

12. Security rights in such notes and certificates of deposit issued by banks are governed by the portion of the secured transactions law addressing security rights in negotiable instruments rather than security rights in bank accounts. There is no reason to distinguish under the secured transactions law negotiable instruments issued by banks from those issued by other persons. Moreover, treating negotiable notes and negotiable certificates of deposit issued by banks as negotiable instruments under the secured transactions law will be consistent with commercial expectations. Parties that deal in negotiable notes or negotiable certificates of deposit typically deal with them as negotiable instruments and not as bank accounts.

Bank account distinguished from a securities account

13. A bank account should also be distinguished from a securities account. While a bank account is a claim of the customer against the depositary bank for a money deposited in the bank account and credited by the bank to the account of the customer, a securities account is a credit owed to the customer by the a bank, broker

or other intermediary for specific securities and other financial assets carried by the intermediary on its books for the account of the customer. [*Note to the Working Group: The Working Group may wish to adopt the same functional approach as in the Unidroit draft Convention. Under the Unidroit draft Convention, " 'securities account' means an account maintained by an intermediary to which securities may be credited or debited", while " 'securities' means any shares, bonds or other transferable financial instruments or financial assets (other than cash) or any interest therein."*] The customer of a securities account usually has a claim against the intermediary for the value of the securities and other financial assets credited to the securities account. The customer also, under the laws of some States, has a rateable proprietary interest in the specific securities and other financial assets held by the intermediary for all of its customers.

14. When a bank maintaining bank accounts also acts as an intermediary maintaining securities accounts, it normally separates bank accounts from securities accounts and uses different numbers or symbols. However, sometimes it may not be apparent whether the bank is acting as a depositary bank with respect to a bank account or as an intermediary with respect to a securities account. If the bank invests the cash deposited to the account in securities and other financial assets and shows on its books the securities and other financial assets as credited to the account, the account is likely to be a securities account rather than a bank account. However, even in that case, at any point in time the account may hold only a cash balance and may arguably at that time be a bank account rather than a securities account.

15. Given the difficulty in some cases in determining whether a particular account at a bank is a bank account or a securities account, it may be important that the secured transactions rules draw a clear distinction between cash and securities, so as to allow market participants to determine in advance the set of conditions that must be met in order to obtain a security right. [In addition, it would be useful if rules relating to bank accounts and securities accounts could either be substantially identical or, if not substantially identical, at least be coordinated so that the secured creditor may generally comply with one general set of rules to be assured that its security right has been created, is effective against third parties, has the requisite priority and is capable of being enforced, regardless of whether the account is viewed as bank account or a securities account.]

16. For the substantive law rules governing security rights in securities accounts, reference should be made to the rules to be proposed by the International Institute for the Unification of Private International Law (Unidroit) Study on Transactions and Transnational and Connected Capital Markets (Study LXXVIII)—Securities Held with an Intermediary. For the conflict-of-laws rules relating to security rights in securities, reference should be made to the Convention on the Law Applicable to Certain Rights in Securities Held with an Intermediary, prepared by the Hague Conference on Private International Law.

4. Creation of the security right as between the parties

17. A secured transactions regime that governs security rights in bank accounts should provide rules by which the security right may be created. Such regimes typically set forth several conditions to be met for the security right to be created.

Secured Obligation

18. As with other security rights, a security right in a bank account must secure an obligation. For example, the creditor may extend credit to the grantor with the security right in the bank account securing the grantor's obligation to pay the credit obligations.

Rights in the bank account

19. Another condition, derived from the general principle that a grantor must have some property right in an encumbered asset, is that the grantor must be the bank's customer on the bank account or otherwise have sufficient rights in the bank account that may be conveyed by way of a security right. In some cases, even if the grantor is a customer of the bank, the grantor may not have sufficient rights in the bank account to create a security right in the bank account without the consent of another customer of the bank. For example, in the event that two or more persons are the joint customer of the bank, it may be that, under the applicable law, no one customer has a right to create a security right in the bank account without the consent of the other joint customers.

Anti-assignment terms

20. If the agreement between the bank and the customer establishing the bank account contains a term by which the customer may not create a security right or otherwise assign its rights in the bank account without the consent of the depositary bank, the consent of the depositary bank may be required for the customer to create a security right in the bank account in favour of the creditor. Even in those States whose laws override anti-assignment terms relating to trade receivables, the override of anti-assignment terms may not go so far as to override an anti-assignment term in an agreement between the customer and the depositary bank relating to the bank account (see articles 4 (f) and 9 (3) of the United Nations Assignment Convention).

21. It may be desirable, however, for the anti-assignment term not to be given effect beyond its intended purpose, which is usually to protect the depositary bank from having to deal with a stranger/assignee as its customer. With this purpose in mind, there would seem to be little justification for applying the anti-assignment term so as to prevent the creation of the security right, so long as the law provides that such a grant of a security right does not create any duty of the depositary bank to recognize the secured creditor, or otherwise impose any obligations on the part of the depositary bank to the secured creditor, without the depositary bank's consent.

Consumer bank accounts

22. The law of a particular State may also prohibit, or apply special rules to restrict, an individual grantor from creating a security right in a bank account where the bank account contains funds used for the grantor's personal, family or household purposes or would secure credit extended to the grantor for such purposes.

23. A State enacting a secured transactions law should consider if and to what extent a security right in a bank account may be created by an individual grantor if the funds in the bank account or the credit obtained are for the grantor's personal, family or household purposes. The State should consider whether the policy

favouring the availability of credit at affordable rates outweighs or should be subordinate to any policy of the State protecting the individual from improvident borrowing and the possible loss of funds needed for the support of the individual and his or her family. Possible approaches may be to prohibit such a security right, to limit the right to certain types of transactions, or to require that the bank account be described more specifically in the security agreement. The policy underlying a requirement for the bank account to be described more specifically in the security agreement is better to inform the individual grantor that the security right is being granted and to indicate that the secured creditor is actually relying on the bank account as an encumbered asset in making its decision to extend credit to the grantor.

Required formalities

24. There may be formality requirements under the laws of a particular State to evidence that the grantor intended to create a security right in the bank account. In some States it may be sufficient for the grantor to evidence the creation of a security right by a writing signed by the grantor and delivered to the secured creditor. Other States may require, additionally or alternatively, that the depositary bank either receive notice of or acknowledge the security right or that the depositary bank agree that it will follow instructions from the secured creditor as to the bank account without further consent from the grantor. It may also be possible for the formality requirements to be met by the secured creditor replacing the grantor as the bank's customer with respect to the bank account.

25. In some States, the formality requirements may include a requirement that the bank account be specifically described in the writing creating the security right. In other States, the bank account may be described more generally. In those States that require, additionally or alternatively, that the depositary bank either receive notice of or acknowledge the security right, or that the depositary bank agree that it will follow instructions from the secured creditor as to the bank account without further consent from the grantor or that the secured creditor replace the grantor as the bank's customer with respect to the bank account, the requirement of a specific description of the bank account is inherent in the requirement of notice to or acknowledgement or agreement by the depositary bank or the substitution of the secured creditor for the grantor as the bank's customer with respect to the bank account.

26. Under the laws of a State, there may be circumstances in which a secured creditor obtains a security right in a bank account automatically (by operation of law or by way of general terms and conditions). First, in some States a depositary bank that extends credit to a customer automatically obtains a security right in the customer's bank account maintained with it. Second, in those States which recognize the concept of a security right continuing in proceeds of other encumbered assets, a secured creditor holding a security right in an encumbered asset may obtain an automatic security right in a bank account to which proceeds of the encumbered asset are credited when the encumbered asset is sold or otherwise disposed of or collected on.

27. However, some States may view any security right of the depositary bank in a bank account maintained with it as nothing more than a right of recoupment or set-off and, accordingly, may not recognize the security right as such.

28. At least as far as formalities are concerned, there seems to be little justification for a State to require, as part of its secured transactions law, different formalities requirements for bank accounts than for receivables or other encumbered assets generally.

Transactional bank accounts

29. The examples described above have not distinguished between transactions in which the grantor retains the right to draw funds from the bank account by issuing cheques or otherwise and those in which that right is restricted. In some States, the ability of the grantor to draw funds from the bank account may be viewed as inconsistent with the State's traditional notion of a pledge by which the secured creditor has the equivalent of possession of the encumbered asset. Similarly, a bank account from which the grantor may draw funds might not be regarded as sufficiently within the possession of the secured creditor so as to permit a security right to have been created.

30. In other States the security right may be created by a grantor even if the grantor has a right to draw funds from the bank account. In those States, the secured creditor's right to stop the grantor from drawing funds from the bank account may be a remedy available to the secured creditor with respect to the security right upon the grantor's default in the payment or performance of the secured obligation. However, the delayed exercise of that remedy by the secured creditor does not impair the creation of the security right.

5. Effectiveness of the security right against third parties

31. As with security rights in other types of property, creation of a security right in a bank account as between the grantor and the secured creditor is an issue that is distinct from effectiveness of that right against third parties. Thus, a secured transactions law which recognizes security rights in bank accounts should set forth what additional steps may need to be taken for the security right, once created, to be effective as against third parties.

32. In some States, a security right in a bank account may become effective against third parties by the secured creditor making a notice or other filing covering the bank account in a security rights registry. For the security right to be effective against third parties under the laws of other States, it may be required that the bank account be assigned to the secured creditor, with the bank either receiving notice of or acknowledging the assignment or the bank agreeing that it will follow instructions from the secured creditor as to the bank account without further consent from the grantor. It may also be possible for a security right in bank account to be effective against third parties by the secured creditor replacing the grantor as the bank's customer with respect to the bank account.

33. In addition, under the laws of some States, if the secured creditor is itself the depositary bank and the security right is recognized as not merely being the depositary bank's right of recoupment or set-off, the security right may be effective against third parties automatically. Even those States that permit a security right to become effective against third parties by a filing in a security rights registry often permit the depositary bank's security right in a bank account maintained with it to be automatically effective against third parties without such a filing. The

justification is that most third party creditors relying on the bank account as an encumbered asset would assume in any event that the depositary bank would have rights of recoupment or set-off that in a large part are the economic equivalent of a security right and which are likely to be superior to a competing security right or judgment right. Of course, such recoupment and set-off rights are not the subject of public filings. Under those circumstances, imposing a filing requirement on the depositary bank for its security right to be effective against third parties would have only marginal, if any, benefit in informing third parties that the depositary bank may have a superior interest in the bank account. However, the cost of imposing a filing requirement upon the depositary bank may be significant depending upon the number of customers of the depositary bank granting security rights in their bank accounts maintained at the depositary bank.

34. When a secured creditor has the legal authority to direct the depositary bank as to the disposition of funds in the bank account without further consent of the grantor as the secured creditor, it is considered that the secured creditor has "control" over the bank account (see definition in A/CN.9/WG.VI/WP.11/Add.1, para. 17 (bb)). Under this definition, the secured creditor would have "control" where: (i) the secured creditor is the depositary bank; (ii) the depositary bank has agreed to follow instructions from the secured creditor with respect to the bank account without further consent of the grantor (the agreement by which the depositary bank has agreed to follow instructions from the secured creditor with respect to the bank account without further consent of the grantor is referred to in this Chapter as a "control agreement"); or (iii) the secured creditor is the bank's customer as to the bank account.

35. Under the laws of some States, a security right in a bank account is effective against third parties when the secured creditor obtains control. Even if the State permits a security right to become effective against third parties by a filing in a security rights registry, the State will often permit the security right to be effective against third parties by the secured creditor achieving control of the bank account as an alternative to such a filing. The justification for doing so is best understood in the context of the State's priority rules in which a security right effective against third parties as a result of the secured creditor achieving control has priority over other security rights. Priority obtained by control is discussed below.

6. Priority of the security right over the rights of competing claimants

36. In addition to rules governing the creation of a security right in a bank account and the effectiveness of such a security right against third parties, the law should set forth priority rules, i.e. rules for ranking claims against the bank account among the secured creditor and competing claimants.

General priority rules based on first in time

37. In those States in which a security right in a bank account can be made effective against third parties by the secured creditor making a filing covering the bank account in a security rights registry, then, once the filing has been made, the security right will usually be entitled to priority over the interests of a competing secured creditor who later asserts priority by making such a filing covering the bank account, of a creditor of the grantor who later obtains a judgment right in the bank

account or of an insolvency administrator of the grantor in the event that an insolvency proceeding is later commenced by or against the grantor.

38. Similarly, in those States in which, for the security right to be effective against third parties, it is required that the bank account be assigned to the secured creditor with the bank either receiving notice of or acknowledging the assignment or the bank agreeing that it will follow instructions from the secured creditor as to the bank account without further consent from the grantor or that the secured creditor replace the grantor as the bank's customer with respect to the bank account, then, once the notice has been given or the acknowledgment or agreement of the bank has been obtained or the secured creditor has become the bank's customer with respect to the bank account, the security right will usually be entitled to priority over the interests of a competing secured creditor who later asserts priority by giving such a notice or obtaining from the bank such an acknowledgment or agreement, of a creditor of the grantor who later obtains a judgment right in the bank account or of an insolvency administrator of the grantor in the event that an insolvency proceeding is later commenced by or against the grantor (if the first secured creditor has obtained priority by becoming the bank's customer with respect to the bank account, then that method of obtaining priority will presumably not be available to a subsequent secured creditor).

39. There may be circumstances under the laws of many States in which a secured creditor's security right in a bank account, which arises automatically, also has automatic priority. In those States in which a depositary bank automatically obtains a security right in a bank account maintained with it, the security right may have automatic priority over other competing interests. In those States that recognize the concept of a security right continuing in proceeds of other encumbered assets, a secured creditor's proceeds interest in a bank account may have automatic priority over certain competing interests, such as a creditor with a judgment right or who had a junior security right in the original encumbered asset.

Exceptions to general priority rules based on first in time

40. While priority disputes relating to a security right are generally resolved on the basis of a "first in time" rule, such a rule may not always be appropriate with respect to a security right in bank account. This is especially the case where it is possible for a security right in a bank account to become effective against third parties by a method, such as making a notice filing in a security rights registry, without the consent or other involvement of the depositary bank.

41. Many parties may deal with the bank account or funds credited to it. In a number of transactions, especially those involving repurchase agreements, securities lending and derivatives, parties act quickly; in some cases on a daily basis. It is not customary or efficient to require these parties to make a notice or other filing in a security rights registry before entering into these transactions. Nor should these parties be burdened with searching in a security rights registry or making other inquiry of possible secured creditors before entering into any bank-account-related transaction.

42. In fact, in some States a security right which has become effective against third parties by the secured creditor making a notice or other filing in a security rights registry may be junior in priority to a security right of which the bank has

been notified or to which the bank has consented or for which the bank has agreed to follow instructions from the secured creditor without further consent from the grantor or where the secured creditor has replaced the grantor as the bank's customer with respect to the bank account. Likewise, in those States that recognize the priority of a security right in a bank account as proceeds, the security right in proceeds may be junior in priority to a security right of which the bank has been notified or to which the bank has consented or for which the bank has agreed to follow instructions from the secured creditor without further consent from the grantor or for which the secured creditor has become the bank's customer with respect to the bank account. In these cases, a "first in time" priority rule may not apply. A security right which becomes effective against third parties on a "first in time" basis may become junior to a later security right if the bank has been notified of or consented to the later security right, or has agreed to follow instructions from the secured creditor relating to the bank account without further consent from the grantor or the secured creditor has become the bank's customer with respect to the bank account, after the first security right has become effective against third parties.

43. Indeed, in those States in which a depositary bank automatically has a security right in a bank account maintained with it, the depositary bank's security right may have priority over all other security rights, whether or not the other security rights have become effective against third parties on a "first in time" basis, unless the depositary bank agrees otherwise.

44. Awarding priority to the depositary bank in this circumstance would appear to be justified in practice. The priority given to a secured creditor that is also the depositary bank is consistent with the superior rights of recoupment and set-off usually enjoyed by the depositary bank. If the secured creditor is not the depositary bank and is relying upon its security right in the bank account, it will in practice either want to become the bank's customer with respect to the bank account or will want to enter into a control agreement or like agreement with the depositary bank to enforce its security right so that following the grant's default the depositary bank will be obligated to turn over the funds in the bank account to the secured creditor. It will also want to the agreement to contain a subordination term by which, if the depositary bank claims a security right in the bank account or has a right of recoupment or set-off, the depositary bank's security right or right of recoupment or set-off will, in most respects, be junior to the security right of the third party secured creditor. If the secured creditor has become the bank's customer with respect to the bank account, the depositary bank may thereafter have no right to set-off funds in the bank account against obligations owed to the depositary bank by the grantor. That is because the mutuality of obligations between the parties (the grantor and the depositary bank) owing money to each other, and typically required for set-off under applicable law, is no longer present.

Transferees of funds from the bank account

45. Of course, a "first in time" priority rule has even less justification with respect to transferees of funds from the bank account, such as payees on cheques drawn on the bank account and recipients of funds transfers. In those States in which the grantor may draw funds from the bank account in which the secured creditor has a security right, transferees of those funds usually take the funds free of any security right in the bank account including, in those States which recognize the concept of

proceeds, free of any proceeds security right in the funds received by the transferee. Otherwise, the secured transactions law of the State would unduly interfere with negotiable instrument law or impair the negotiability of money, cheques and credit transfers among banks and other persons.

7. Enforcement of the security right as against the grantor

46. A secured transactions law which recognizes a security right in a bank account should contain clear legal rules for the efficient enforcement of the security right.

Enforcement in general

47. When a secured creditor has a security right in a bank account, and the grantor has defaulted on its obligation, the secured creditor will be entitled to enforce the security right. Enforcement in this context typically consists of the secured creditor obtaining from the depositary bank the funds credited to the bank account and then applying the funds to the secured obligation. In the case where the secured creditor is the depositary bank or is the depositary bank's customer with respect to the bank account, the secured creditor may simply apply the credit balance in the bank account to the secured obligation.

Necessity for resort to judicial process or court supervision

48. As with other types of property in which a security right may be created, the secured transactions law must determine the extent to which enforcement of the security right may be accomplished without resort to judicial process and otherwise without court supervision. A requirement for the secured creditor to use judicial process or be under court supervision to enforce its security right increases the costs of and delays enforcement, thereby increasing the costs of credit both for those obligors who default on their credit obligations and for those obligors who do not. On the other hand, a requirement that the secured creditor use judicial process or be under court supervision to enforce its security right may be necessary where there is a good faith dispute as to the secured creditor's right to enforce its security right, where there is a danger to the public order or where there is a strong possibility of secured creditor abuse.

49. There would seem to be little justification for a State to require that a secured creditor use judicial process or be under court supervision to enforce its security right in a bank account, especially in three cases. The first is where the depositary bank is itself the secured creditor. In that case, it would seem of little value to require the secured creditor to use judicial process or be under court supervision in order to apply a claim owed to its customer to a claim owed by its customer to it. This is especially true where the secured creditor, as depositary bank, also has under the law of the State a right of recoupment or set-off that could be exercised by the secured creditor as depositary bank without resort to judicial process or court supervision. The exercise of the right of recoupment or set-off largely produces the same economic result as the exercise of a security right. It would seem to make little sense to require resort to judicial process or court supervision in one case but not the other.

50. The second case is where the depositary bank has already agreed by contract with the secured creditor and the grantor to transfer the funds in the bank account to

the secured creditor upon its instructions, without further consent of the grantor. In that case, since the contract was specifically negotiated with the grantor and the depositary bank, the need for use of judicial process or court supervision would likewise appear to be superfluous so long as the agreement of the grantor is a binding contractual one.

51. The third case is where the secured creditor has replaced the grantor as the depositary bank's customer with respect to the bank account. Here also there would appear to be no need for judicial process or court supervision since the secured creditor already has the right to deal with the bank account as the bank's customer.

52. There may perhaps appear to be a greater justification to require that a secured creditor use judicial process or be under court supervision in some circumstances to enforce its security right in a bank account when the credit extended or the bank account itself is for the personal, family or household purposes of an individual grantor. Even then it would seem of little value to require the use of judicial process or court supervision for enforcement of the security right when the depositary bank is the secured creditor and would have a right of recoupment or set-off in any event.

8. Rights and duties of the depositary bank

53. Any method of enforcement of a security right in a bank account by a secured creditor that is not the depositary bank raises issues as to the rights and duties of the depositary bank in the absence of the secured creditor's resort to judicial process or court supervision of enforcement and the issuance of a judicial order covering those rights and duties. A secured transactions law that recognizes a security right in a bank account should provide clear legal rules setting forth the rights and duties of the depositary bank relating to the security right.

54. While one could argue that the subject of the rights and duties of the depositary bank is largely a question of priority, a fuller discussion of the subject may be useful to illustrate the importance of addressing the subject with respect to creation, effectiveness against third parties, priority and enforcement of the security right even if already discussed above. This is because of the unique role played by the depositary bank in its capacity as a debtor with respect to the claim of the bank's customer against the depositary bank on the bank account.

Contrast with rights and duties of a debtor on a trade receivable

55. Indeed, to address the rights and duties of the depositary bank in the absence of a judicial order doing so, it is important to distinguish the rights and duties of a debtor on a trade receivable from the rights and duties of a depositary bank with respect to a bank account. In the case of a security right in a trade receivable, the security right might still be effective against the debtor on the receivable even if the original contract under which the trade receivable arose contained an anti-assignment term (see article 9 of the Assignment Convention). Moreover, in the case of a security right in a trade receivable, the secured creditor is usually entitled to notify the debtor on the receivable to pay the secured creditor (see article 13 (1) of the Assignment Convention). The debtor may then not be entitled to a discharge on its payment of the receivable unless the debtor pays the secured creditor (see article 17 of the Assignment Convention).

56. However, where the debtor is a depositary bank with respect to a bank account, the depositary bank may not necessarily be subject to the same rules under the laws of a particular State (see article 4 (f) of the Assignment Convention). Instead, the depositary bank may have certain rights, and no or few duties, to accept or refuse the creation, priority or enforcement of a security right in the bank account in some circumstances.

Depositary bank's consent to the creation of the security right as between the parties, the effectiveness of the security right against third parties and the priority of the security right

57. As explained above, under the laws of some States, the depositary bank's consent or other involvement may be required for the grantor to create a security right in a bank account, for the security right to be effective against third parties or for the security right to have priority.

(a) The depositary bank's consent may be required for the grantor to create a security right in a bank account. This may be the case if the agreement between the grantor and the depositary bank establishing the bank account contains a term restricting the grantor's right to create a security right without the consent of the bank. It may also be the case under the laws of some States that the depositary bank's consent, by way of acknowledgment of the security right or agreement with the secured creditor, may be required for the grantor to create the security right even if the agreement between the grantor and the depositary bank establishing the bank account does not contain a term restricting the grantor from creating the security right;

(b) The involvement of the depositary bank, by way of acknowledgment of the security right or agreement with the secured creditor, may likewise be required for the secured creditor's security right to be effective against third parties under the laws of some States;

(c) The involvement of the depositary bank, by way of acknowledgment of the security right or agreement with the secured creditor, may be required for the secured creditor's security right to have priority over any security right in the bank account in favour of the depositary bank itself.

Enforcement of the security right as against the depositary bank

58. In addition, under some circumstances the consent of the depositary bank may be required for the secured creditor to enforce a security right in the bank account.

59. In those States in which the security right in a bank account is effective against third parties on account of a notice or other filing in a security rights registry or by reason of notice of assignment to or acknowledgment of assignment by the depositary bank, the filing, notice or acknowledgment may or may not impose duties on the depositary bank to follow instructions from the secured creditor as to the funds in the bank account when the secured creditor wishes to enforce the security right. If such duties are not imposed on the depositary bank under the applicable laws of a particular State, the secured creditor's right to obtain the funds in the bank account upon enforcement of the security right would usually depend upon whether the customer has instructed the depositary bank to follow the secured

creditor's instructions as to the funds or the depositary bank has agreed with the secured creditor to do so.

60. In the absence of such instructions or agreement, the secured creditor may need to enforce the security right in the bank account by using judicial process to obtain a court order requiring the depositary bank to turn over the funds in the bank account to the secured creditor.

[*Note to the Working Group: Part A. General Remarks, the rest of Section 8 and Sections 9 to 11, as well as Part. B, Recommendations, are contained in document A/CN.9/WG.VI/WP.18/Add.1.*]