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## Security Interests

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

#### Note by the Secretariat

#### Addendum

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

### Purpose

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

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

### Methods for achieving third-party effectiveness

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

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

*[Note to the Working Group: The Working Group may wish to consider additional methods for achieving third-party effectiveness (e.g. automatic third-party effectiveness upon creation of a security right in consumer goods. The Working Group may also wish to consider whether, in the case of assets subject to registration in a specialized registry or to a title certificate registration system, in addition to registration in a specialized title registry or a title certificate, registration of a notice in the general security rights registry should also be required. The advantage of such an additional registration requirement would be that a search in the security rights registry would reveal all security rights in a wide range of assets, including those that are subject to a specialized registration system.]*

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

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

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

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

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

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

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

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

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

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

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

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

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

### **Advance registration**

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

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

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

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

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

*[Note to the Working Group: The Working Group may wish to note that, if the registration system permits paper notices or requires that a notice, whether in paper or electronic form, needs to be checked or verified before being entered into the record, there will be some delay between receipt of the notice by the registrar and the time the notice will be entered into the record and become available to searchers. In such circumstances, the question arises as to the time when the registration should be effective, the time of receipt of the notice by the registrar or the time the notice is entered into the record and becomes available to searchers. If the registration is effective when received by the registrar, a search will not disclose all legally effective registrations. If the registration is effective as of the time the notice is entered into the record and made available to searchers, the registering party has the risk associated with any delay. In a fully electronic system that requires no verification of registered data by the registrar, the time difference*

*between receipt of the data by the registrar and their availability to searchers is minimal and this problem is significantly reduced.]*

### **Discharge of registration**

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

### **Additional rights subject to registration**

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

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

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

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

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

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

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

### **Dispossession of the grantor**

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

*[Note to the Working Group: The Working Group may wish to note that no recommendation is included on third-party effectiveness of security rights in negotiable instruments. Asset-specific recommendations are included only where the general recommendations are not applicable to certain types of asset (with the exception of recommendation 70 which is included for the sake of completeness of the recommendations on priority of security rights in fixtures). The recommendations on negotiable instruments, independent undertakings and*

*negotiable documents appear within square brackets as the Working Group has not decided yet that those types of asset should be addressed in the Guide.]*

### **Independent undertakings**

49. [The law should provide that a security right in the proceeds from the drawing under an independent undertaking may be made effective against third parties by:

- (a) Control;
- (b) Possession of the original text of the independent undertaking if presentation of it is a condition to payment;
- (c) Registration of a notice in the security rights registry with respect to the proceeds or the underlying receivable; or
- (d) Automatically upon creation of a security right in the receivable supported by an independent undertaking.]

*[Note to the Working Group: Under the definition of control in the terminology section, the secured creditor has control of an independent undertaking where: (i) the issuer/guarantor or nominated person paying the proceeds is the secured creditor; (ii) the issuer/guarantor or nominated person paying the proceeds has acknowledged the security right in the proceeds from the drawing under an independent undertaking; or (iii) the secured creditor is the beneficiary. Under the third method of obtaining control, as between the issuer/guarantor or nominated person paying the proceeds and the secured creditor, the secured creditor is the beneficiary of the independent undertaking. It may be that, as between the grantor and the secured creditor, the secured creditor has agreed to treat the proceeds as encumbered assets. Any such agreement does not affect the relationship between the issuer/guarantor or nominated person paying the proceeds and the beneficiary (the secured creditor). It only gives the secured creditor "control" for purposes of the effectiveness of its rights against third parties.]*

### **Bank accounts**

50. The law should provide that a security right in a bank account may be made effective against third parties through registration of a notice in the security rights registry or through the control of the bank account.

51. If the secured creditor and the depositary institution are the same person, the law should provide that the secured creditor automatically has control upon the creation of the security right.

### **Negotiable documents of title**

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

53. The law should provide that, if a security right in a negotiable document is effective against third parties, the corresponding security right in the goods represented by the document is also effective against third parties.]

**Proceeds**

54. The law should provide that, if a security right in encumbered assets is effective against third parties, the security right in the proceeds is effective against third parties as soon as the right in the proceeds is created provided that:

(a) The security right in the encumbered assets was made effective against third parties by registration [and the proceeds are a kind of asset in which a security right may be made effective against third parties by registration];

*[Note to the Working Group: Paragraph (a) would not apply, for example, to a security right in inventory which was made effective against third parties by possession, although the security right in the proceeds in the form of receivables would have to be registered.]*

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

(c) If neither (a) nor (b) applies, the security right in the proceeds is effective against third parties for [...] days and continuously thereafter if it is made effective against third parties by one of the methods referred to in recommendation 35.

**Fixtures**

55. The law should provide that a security right in fixtures in immovables or in movables becomes effective against third parties by one of the methods referred to in recommendation 35. With respect to security rights in fixtures in immovables, the law should provide that registration under this law does not preclude registration under real property law.

*[Note to the Working Group: With respect to security rights in fixtures in immovables, the Working Group may wish to consider whether a notation in the real property registry should be required.]*

56. If a security right is effective against third parties at the time when the encumbered assets become fixtures in movables, the security right in the encumbered assets remains effective against third parties.

**Products or masses of goods**

57. If a security right is effective against third parties at the time the encumbered assets are physically united with other goods in such a way that their identity is lost in a product or mass of goods, the security right in the product or mass remains effective against third parties.

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

**Purpose**

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

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

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

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

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

#### **Secured obligations affected**

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

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

(b) Is unaffected by the date on which an advance or other obligation secured by the security right is made or incurred (i.e. a security right may secure future advances under a credit facility with the same priority as advances made under the credit facility at the time the security right is made effective against third parties).

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

60. The law should specify that a security right in after-acquired or after-created assets of the grantor has the same priority as a security right in assets of the grantor owned or existing at the time the security right is made effective against third parties.

#### **Negotiable instruments**

61. [The law should provide that a security right in a negotiable instrument that has been made effective against third parties by a method other than possession of the instrument by the secured creditor is subordinate to the rights of a buyer, another secured creditor or other transferee in a consensual transaction who either:

(a) Qualifies as a protected holder under the law governing negotiable instruments; or

(b) Otherwise takes possession of the negotiable instrument in good faith and without knowledge that the transfer was in violation of the rights of the holder of the security right.]

#### **Independent undertakings**

62. [The law should provide that a security right in the proceeds from the drawing under an independent undertaking that has been made effective against third parties:

(a) By control has priority over the rights of all other secured creditors;

(b) By acknowledgement has priority over a security right made effective by any method other than control to the extent the proceeds are payable under and pursuant to the terms of that acknowledgement; in the case of inconsistent acknowledgements given by the same person, the first secured creditor to obtain an acknowledgement from that person has priority;

(c) By possession has priority over a security right made effective against third parties automatically upon creation or by registration; and

(d) Automatically upon creation has priority, in accordance with its priority in the underlying receivable and in the proceeds from the drawing under an independent undertaking, over a security right made effective against third parties by registration.]

### **Bank accounts**

63. The law should provide that a security right in a bank account which has been made effective against third parties by control has priority over a security right in that bank account which has been made effective against third parties by another method. If the secured creditor is the depositary bank, the depositary bank's security right has priority over any other security right.

64. The law should provide that the depositary bank's right to set-off against the bank account obligations owed to the depositary bank by the grantor has priority over the security right of another secured creditor other than a secured creditor who has acquired control of the bank account by becoming the customer of the depositary bank with respect to the bank account.

65. In the case of a funds transfer from a bank account initiated by the grantor, the transferee of funds takes free of a security right in the funds of the bank account [unless the transferee has knowledge that the transfer violates the terms of the security agreement and the transfer is outside the ordinary course of business of the grantor].

### **Negotiable documents**

66. [The law should provide that, while goods are in the possession of a person who has issued a negotiable document with respect to them, a security right in those goods that became effective against third parties by making a security right in the negotiable document effective against third parties has priority over another security right in the goods that was made effective against third parties by a different method [while the goods were in the possession of the issuer or [...]] [while the document of title is outstanding].

67. The law should provide that a security right in a negotiable document and the goods represented thereby is subject to the rights under the law governing negotiable documents of a person to whom the negotiable document has been duly negotiated.]

### **Proceeds**

68. The law should provide that a secured creditor's priority with respect to an encumbered asset extends to the proceeds of the asset subject to the requirements of recommendation 54.

### **Fixtures and products or masses of goods**

69. The law should provide that a secured creditor with a security right in fixtures in immovables that has been made effective against third parties under real property law has priority over a secured creditor with a security right in those fixtures that has been made effective against third parties by one of the methods referred to in recommendation 55.

70. The law should provide that the priority of security rights in fixtures in movables is governed by the general rules applicable to movable property.

71. The law should set forth rules governing the priority of security rights in goods that are physically united with other goods in such a way that their identity is lost in a product or mass of goods.

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

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

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

#### **Unsecured creditors**

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

#### **Secured creditors**

74. The law should provide that:

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

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

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

#### **Unsecured creditors**

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

#### **Secured creditors**

76. The law should provide that:

(a) As between two security rights in the same encumbered asset that are effective against third parties, except as provided in recommendation [on priority of acquisition financing devices], priority is determined by the order in which their respective third-party effectiveness steps occurred, even if one or more of the requirements for the creation of a security right was not satisfied at such time. If one of the security rights is made effective against third parties by possession or control of the encumbered asset, the holder of that security right will have the burden of establishing when it obtained possession or control;

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

### **Judgement creditors**

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

### **Buyers of encumbered assets**

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

### **Reclamation claims**

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

### **Lessees**

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

### **Holders of promissory notes and negotiable documents**

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

### **Holders of rights in money**

82. The law should provide that a person in possession of money holds the money free of a security right in the money [if that person gives value for the money or has no knowledge that the transfer of the money to that person violates the terms of the security agreement. This recommendation does not lessen the rights of holders of money under law other than this law].

### **Statutory (preferential) creditors**

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

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

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

### **Creditors in insolvency proceedings**

*[Note to the Working Group: See recommendation I in the recommendations of this Guide on Insolvency: “The insolvency law should specify that, if a security right is entitled to priority under law other than the insolvency law, that priority continues unimpaired in insolvency proceedings except if, pursuant to the insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to Recommendation 88 of the Insolvency Guide.”]*

### **Subordination agreements**

85. The law should provide that a holder of a security right entitled to priority may at any time subordinate its priority unilaterally or by agreement in favour of any existing or future competing claimant.

*[Note to the Working Group: As to subordination agreements in the case of the grantor’s insolvency, see recommendation J in the recommendations of this Guide on Insolvency: “The insolvency law should provide that if a holder of a security right in an asset of the insolvency estate has subordinated its priority unilaterally or by agreement in favour of any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the grantor.”]*