United Nations

A/CN.9/WG.VI/WP.22/Add.1

# General Assembly

Distr.: Limited
24 June 2005*

Original: English

**United Nations Commission on International Trade Law**
Working Group VI (Security Interests)
Eighth session
Vienna, 5-9 September 2005

## Security Interests

## Draft legislative guide on secured transactions

### Note by the Secretariat

**Addendum**

## Contents



* This document is submitted four days 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.05-85983 (E) 030805 040805

# I. Introduction

## A. Purpose

1. The purpose of this Guide is to assist States in the development of modern secured transactions laws with a view to promoting the availability of low-cost secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.

2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (particularly small and medium-size enterprises), and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making low-cost consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see UNCITRAL Legislative Guide on Insolvency Law).

3. The Guide seeks to rise above differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable, yet limited, costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.

5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of payment in the event of non-payment of the secured obligation. As the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. On the other hand, in States that do not have efficient and effective laws, where creditors perceive the legal risks

associated with credit transactions to be high, the cost of credit increases as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime, or of an insolvency law regime under which security rights are recognized, has resulted in the virtual elimination of credit for small and medium-size commercial enterprises, as well as for consumers.

7. By aiding in the cultivation and growth of individual businesses, creating a legal regime that promotes secured credit can have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves a valuable economic benefit.

8. To best promote the availability of low-cost secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their property to the maximum extent possible to obtain credit. In this regard, the Guide adopts two of the most essential concepts of successful secured transactions laws, the concepts of priority and effectiveness against third parties. The concept of priority, which allows for the concurrent existence of security rights having different priority status in the same assets, makes it possible for a business to utilize the value of its assets to the maximum extent possible by obtaining secured credit from more than one creditor using the same assets as security with transparent rules allowing each creditor to know the priority of its security right. The concept of effectiveness against third parties, in the form of a system allowing, inter alia, the registration of a notice concerning security rights, is designed to promote legal certainty with regard to the relative priority status of creditors and thus to reduce the risks and costs associated with secured transactions.

## B. Scope

9. The Guide deals with consensual security rights. However, it contains references to non-consensual rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.14/Add.1, paras. 56-61 and 82-85). The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of asset are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, both tangible and intangible, with the exception of assets specifically excluded.

10. Real property, securities and wages are types of asset that are subject to an outright exclusion. Real property (with the exception of fixtures, which are covered by the Guide and can be subjected to security rights) is excluded as it raises different issues and is subject to a special title registration system indexed by asset and not by grantor. In addition, the Guide does not cover security rights in securities as original encumbered assets because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. The substantive law issues relating to security and other rights in securities held with an intermediary are dealt with in a draft

Convention being prepared by the International Institute for the Unification of Private Law (Unidroit). The private international law issues with respect to that subject matter are not addressed in this Guide since they are dealt with in the Hague Convention on the Law applicable to Certain Rights in Respect of Securities (The Hague, December 2002). The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by Unidroit and the Hague Conference, as well as relevant texts prepared by UNCITRAL, such as the United Nations Convention on the Assignment of Receivables in International Trade (New York, December 2001; herein after referred to as "the United Nations Assignment Convention") and the UNCITRAL Legislative Guide on Insolvency Law.

[*Note to the Working Group: The Working Group may wish to consider whether security rights in directly-held securities, whether certificated or uncertificated, should be addressed in the Guide. The Working Group may also wish to address the question of which regime applies to securities as proceeds of types of asset that are within the scope of the Guide, their special regime or the general regime of the Guide applicable to proceeds. A related question that the Working Group may wish to address is whether proceeds from drawings of independent undertakings are subject only to the special rules in the Guide or also to the rules applicable to proceeds generally. The same question arises with respect to receivables, negotiable instruments, negotiable documents and bank accounts.*]

11. Security rights in wages are excluded based on the policy of protecting individual and family life. Any additional exclusions based on competing policy objectives should be limited in number and in scope, should be clearly stated in the law and should be adopted only after their potential benefit has been carefully weighed against the social and economic policy underlying the secured transactions law of promoting the availability of low-cost credit.

12. Some assets, such as ships, aircraft [and intellectual property rights] are in whole or in part subject to special laws. Security rights in such assets are not excluded but, in the case of any inconsistency between such a special law and secured transactions law, the special law (e.g. the special registration system) prevails.

13. [In particular, the Guide does not address issues specific to security rights in intellectual property rights and it does not make recommendations concerning those issues. However, in developing its secured transactions law, a State should take account of the increasing importance and economic value of intellectual property assets to companies seeking to obtain low-cost secured credit. Subject to the limitations discussed in the following paragraph, the secured transactions law would apply to security interests in intellectual property rights.

14. When adopting a secured transaction regime, a State should take into account the particular characteristics of, and national laws applicable to, intellectual property, as well as the State's obligations under international intellectual property treaties, conventions and other international agreements. Accordingly, when implementing the recommendations of the Guide, a State should give careful consideration to situations in which the existing legal regime and characteristics of intellectual property are sufficiently unique as to justify the adjustment of those recommendations when the encumbered assets include intellectual property rights.

If upon examination there is found to be a direct inconsistency between the State's intellectual property laws or obligations under intellectual property treaties, conventions and other international agreements, in particular insofar as they establish a rule for the creation, effectiveness against third parties, priority or enforcement of security rights in intellectual property, then the State's secured transactions law should provide that the intellectual property laws and obligations will govern such issues to the extent of any inconsistency.]

[*Note to the Working Group: The Working Group may wish to note that references to negotiable instruments, negotiable documents, intellectual property rights and proceeds from drawings under independent undertakings appear within square brackets pending a decision of the Working Group as to whether they should be included in the Guide. After all of the substantive recommendations of the Guide have been completed, the Working Group may wish to align the recommendations on scope with the substantive recommendations.*]

15. The Guide stresses the need to enable a grantor to create security rights not only in its existing assets but also in its future assets (i.e. assets acquired or created after the conclusion of the security agreement), without requiring the grantor or secured creditor to execute any additional documents or to take any additional action at the time such assets are acquired or created. This approach is consistent, for example, with the United Nations Assignment Convention, which provides for the creation of security rights in future receivables without requiring any additional steps to be taken. In addition, the Guide recommends recognition of a security right in all existing and future assets of a business grantor through a single security agreement such as already exists in some legal systems as an "enterprise mortgage" or as a combination of fixed and floating charges.

16. The Guide also recommends that a broad range of obligations, monetary and non-monetary may be secured, and that both physical and legal persons may be parties to a secured transaction, including consumers, subject to consumer-protection laws. In addition, the Guide is intended to cover a broad range of transactions that serve security functions, including those related to possessory and non-possessory security rights, as well as transactions not denominated as secured transactions (such as retention of title, transfer of title for security purposes, assignment of receivables for security purposes, financial leases, and sale and leaseback transactions and the like).

17. The legal regime envisaged in the Guide is a purely domestic regime. The recommendations of the Guide are addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the recognition of security rights and title-based security devices, such as retention of title and financial leases, effectively created in other jurisdictions. This would represent a marked improvement for the holders of those rights over the laws currently in effect in many States, under which such rights often are lost once an encumbered asset is transported across national borders, and would go far toward encouraging creditors to extend credit in cross-border transactions (see A/CN.9/WG.VI/WP.14/Add.4, paras. 21-25).

18. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons,

buyers and other transferees, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that all creditors will accept such a balanced approach, and will thereby be encouraged to extend credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately realize the economic value of the encumbered assets. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since this matter does not lend itself to unification.

19. In the same spirit, the Guide also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. Another concern is the potential ability of a secured creditor to exercise influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. Yet another concern is that in some cases secured creditors may take most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, some of whom are not in a position to bargain for a security right in those assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, suggests solutions.

20. The Guide builds on the work of UNCITRAL and other organizations. Such work includes: the United Nations Assignment Convention; the UNCITRAL Legislative Guide on Insolvency Law; the Convention on International Interests in Mobile Equipment, approved in November 2001; the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD General principles of a modern secured transactions law, completed in 1997; the study on Secured Transactions Law Reform in Asia, prepared by the Asian Development Bank in 2000; the Organization of American States (OAS) Model Inter-American Law on Secured Transactions, prepared in 2002; and the OHADA Uniform Act Organizing Securities, prepared in 1997 […].

## C. Terminology

21. This Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given to the term may differ. This approach is taken to provide readers with a common vocabulary and conceptual framework and to encourage harmonization of the law governing security rights. The following paragraphs therefore identify the principal terms used and the core meaning given to them in this Guide. The meaning of those terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms.

(a) “Security right” means a consensual property right in movable property and fixtures that secures payment or other performance of one or more obligations.

(b) “Acquisition security right” means a security right in an asset that secures the obligation to pay any unpaid portion of the purchase price of the asset or other obligation incurred to enable the grantor to acquire the asset. Acquisition security rights include those that are denominated as security rights, as well as those that are denominated as retention of title, arrangements and financial leases.

(c) “Secured obligation” means the obligation secured by a security right.

(d) “Secured creditor” means a creditor that has a security right.

(e) “Debtor” means a person that owes performance of the secured obligation [and includes secondary obligors, such as guarantors of a secured obligation]. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor).

(f) “Grantor” means a person that creates a security right in one or more of its assets in favour of a secured creditor to secure either its own obligation or that of another person (see debtor).

(g) “Security agreement” means an agreement between a grantor and a creditor, in whatever form or terminology, that creates a security right.

(h) “Encumbered asset” means property that is subject to a security right. The property may be tangible or intangible. Each of these two general types of property includes various categories, some of which fall within particular defined terms used in the Guide.

(i) “Tangibles” means all forms of corporeal movable property. Among the categories of tangibles are inventory, equipment, fixtures, negotiable instruments and negotiable documents.

(j) “Inventory” means a stock of tangibles (other than negotiable instruments and negotiable documents) held for sale or lease in the ordinary course of business and also raw and semi-processed materials (work-in-process).

(k) “Equipment” means tangibles (other than negotiable instruments, negotiable documents and inventory), used by a person in the operation of its business.

(l) “Fixtures in immovables” means tangibles (other than negotiable instruments and negotiable documents), that can become subject to separate security rights even though they are so closely attached to or associated with immovable property as to be treated as immovable property under the law of the State where the immovable property is located. “Fixtures in movables” means tangibles (other than negotiable instruments and negotiable documents) that can become subject to separate security rights even though they are closely associated with other movable property, without however losing their identity. “Mass or product” means tangibles (other than negotiable instruments or documents) that are so closely associated with each other that they cannot become subject to separate security rights.

(m) “Intangibles” means all forms of movable property other than tangibles. Among the categories of intangibles are claims and receivables.

(n) “Claim” means a right to the performance of a non-monetary obligation other than a right in tangibles under a negotiable document.

(o) “Receivable” means a right to the payment of a monetary obligation, excluding, however, rights to payment evidenced by a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay with respect to a bank account.

(p) “Assignment” means the creation of a security right in a receivable or the transfer of a receivable, whether the transfer is for security purposes or is an [absolute] [outright] transfer. [Note to the Working Group: Article 2 (a) of the United Nations Assignment Convention.]

(q) “Assignor” means the person that makes an assignment of a receivable. [Note to the Working Group: Article 2 (a) of the United Nations Assignment Convention.]

(r) “Assignee” means the person to which an assignment of a receivable is made. [Note to the Working Group: Article 2 (a) of the United Nations Assignment Convention.]

(s) “Subsequent assignment” means an assignment by the initial or any other assignee. In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee. [Note to the Working Group: Article 2 (b) of the United Nations Assignment Convention.]

(t) “Account debtor” means a person liable for payment of a receivable. [Note to the Working Group: Article 2 (a) of the United Nations Assignment Convention.]

(u) “Notification of the assignment” means a communication in writing that reasonably identifies the assigned receivables and the assignee [Note to the Working Group: Article 5 (d) of the United Nations Assignment Convention.]

(v) “Original contract” in the context of an assignment means the contract between the assignor and the account debtor from which the assigned receivable arises. [Note to the Working Group: Article 5 (a) of the United Nations Assignment Convention.]

(w) “Negotiable instrument” means, subject to law other than secured transactions law, an instrument that embodies a right to payment, such as a promissory note or a bill of exchange, which satisfies the requirements for negotiability under the law governing negotiable instruments.

(x) “Negotiable document” means, subject to law other than secured transactions law, a document that embodies a right for delivery of tangibles, such as a warehouse receipt or a bill of lading, which satisfies the requirements for negotiability under the law governing negotiable documents.

(y) [“Independent undertaking” means, subject to law other than secured transactions law, a letter of credit (commercial or standby), independent guarantee (demand, first demand, or bank guarantee), and other undertaking recognized as independent by law or practice rules, such as the United Nations Convention on Independent Guarantees and Standby Letters of Credit, the Uniform Customs and

Practice for Documentary Credits, the International Standby Practices, and the Uniform Rules of Demand Guarantees.

(z) “Proceeds from a drawing under an independent undertaking” means the beneficiary-grantor’s right to receive a payment made, a draft accepted, a deferred payment obligation incurred, or other item of value delivered by the issuer/guarantor in honouring, or by a nominated person in giving value for, a drawing under an independent undertaking. The term does not include the beneficiary-grantor's right to draw under an independent undertaking.

(aa) “Guarantor/Issuer” means a bank or other person that issues an independent undertaking. The term includes a bank or other person that confirms the independent undertaking (“confirmer”).

(bb) “Nominated person” means a bank or other person that is identified in an independent undertaking by name or type (e.g. “any bank in country X”) as being nominated to give value, i.e. to purchase or pay upon presentation of documents, and that acts pursuant to that nomination. The term includes a confirmer that is nominated to confirm and that confirms pursuant to the nomination.]

(cc) “Bank account” means, subject to law other than secured transactions law, an account maintained by a bank into which funds may be deposited. The term includes checking, saving and time-deposit accounts.

(dd) [“Intellectual property right” includes, subject to law other than the secured transactions law, patents, trademarks, service marks, trade secrets, copyright and related rights and designs. It also includes rights under licences of such rights.]

(ee) “Proceeds” means whatever is received in respect of encumbered assets, including what is received as a result of sale, lease or other disposition or collection, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from damage or loss, and tort or warranty claims. [It does not include proceeds from drawings under independent undertakings or types of asset excluded from the scope of the Guide as original encumbered assets.]

(ff) “Priority” means the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant.

(gg) “Competing claimant” means:

(i) Another secured creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);

(ii) The seller or financial lessor of the same encumbered asset that has retained title to it pursuant to an acquisition security right;

(iii) Another creditor of the grantor asserting a right in the same encumbered asset (e.g. by operation of law, attachment or seizure or a similar process);

(iv) The insolvency representative in the insolvency of the grantor; or

(v) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset.

(hh) “Control” means the legal authority of a secured creditor to direct the disposition of an encumbered asset that is either a bank account or a right to proceeds under an independent undertaking without the need of any further consent or other action by the grantor.

(ii) "Possessory security right" means a security right in tangibles that are in the actual possession of the secured creditor or of another person (other than the debtor or other grantor) holding the asset for the secured creditor.

(jj) "Non-possessory security right" means a security right in: (i) tangibles that are not in the actual possession of the secured creditor or another person holding the tangibles for the benefit of the secured creditor, or (ii) intangibles.

(kk) "Insolvency court" means a judicial or other authority competent to control or supervise an insolvency proceeding.

(ll) "Insolvency estate" means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings.

(mm) "Insolvency proceedings" means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor's business conducted according to the insolvency law.

(nn) "Insolvency representative" means a person or body responsible for administering the insolvency estate.

(oo) "Buyer in the ordinary course of business" means a person that buys inventory in the ordinary course from a person in the business of selling tangibles of that kind and without knowledge that the sale violates the security rights or other rights of another person in the tangibles.

## D. Examples of financing practices covered in the Guide

22. Set forth below are short examples of the types of secured credit transactions that the Guide is designed to encourage, and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use, and an effective secured transactions regime must be sufficiently flexible to accommodate many existing methods of financing, as well as methods that may evolve in the future.

### 1. Inventory and equipment acquisition financing

23. Businesses often obtain financing for specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the tangibles (inventory and equipment) purchased. In other cases, the financing is provided by a lender. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller retains title or the lender is granted a security right in the tangibles purchased to secure the repayment of the credit or loan.

24. Here is an illustration of acquisition financing: ABC Manufacturing Company (ABC), a manufacturer of furniture, wishes to acquire certain inventory and equipment for use in manufacturing operations. ABC desires to purchase paint

(constituting raw materials and, therefore, inventory) from Vendor A. ABC also wishes to purchase certain drill presses (constituting equipment) from Vendor B and certain conveyor equipment from Vendor C. Finally, ABC wishes to lease certain computer equipment from Lessor A.

25. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within thirty days of Vendor's A invoice to ABC, and ABC grants to Vendor A a security right in the paint to secure the purchase price. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the drill presses within ten days after they are delivered to ABC's plant. ABC obtains a loan from Lender A to finance the purchase of the drill presses from Vendor B, secured by a security right in the drill presses. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the bank account as additional security for the repayment of the loan.

26. Under the purchase agreement with Vendor C, ABC is required to pay the purchase price for the conveyor equipment when it is installed in ABC's plant and rendered operational. ABC obtains a loan from Lender B to finance the purchase and installation of the conveyor equipment from Vendor C, secured by a security right in the conveyor equipment.

27. Under the lease agreement with Lessor A, ABC leases the computer equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a "financial lease". Under some forms of financial lease, title to the leased property is transferred to the lessee automatically at the end of the lease term. A financial lease is to be distinguished from what is usually called an "operating lease". Under an operating lease, the leased property is expected to have a remaining useful life at the end of the lease term and the lessee does not have an option to purchase the leased property at the end of the lease term for a nominal price, nor is title to the leased property transferred to the lessee automatically at the end of the lease term.

28. In each of the above four cases, the acquisitions are made possible by means of acquisition financing provided by another person (seller, lender or financial lessor) who holds rights in the acquired property for the purpose of securing the acquisition financing granted. As the illustrations make clear, acquisition financing can occur with respect to both inventory and equipment.

### 2. Inventory and receivable revolving loan financing

29. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

30. One highly effective method of providing such working capital is a revolving loan facility. Under this type of credit facility, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs (see also A/CN.9/WG.VI/WP.11/Add.2, para. 12). The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Thus, borrowings and repayments are frequent (though not necessarily regular) and the amount of the credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower, and helps the borrower to avoid borrowing more than it actually needs.

31. Here is an illustration of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving loan facility to ABC to finance this process. Under the line of credit, ABC may obtain loans from time to time in an aggregate amount of up to 50 per cent of the value of its inventory that Lender B deems to be acceptable for borrowing (based upon its type and quality, as well as other criteria) and of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the account debtors). ABC is expected to repay these loans from time to time as it receives payments from its customers. The line of credit is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the bank account into which customer payments (i.e. the proceeds of inventory and receivables) are deposited.

### 3. Term-loan financing

32. Businesses often need financing for large, non-ordinary-course expenditures, such as the acquisition of equipment or the acquisition of a business. In these situations, businesses generally seek financing that such loans are repaid over a fixed period of time (with principal being repaid in monthly or quarterly instalments pursuant to an agreed-upon schedule or in a single payment at the end of the loan term).

33. For businesses that do not have strong, well-established credit ratings, term loan financing will generally be available only if the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, real property is the only type of asset that is accepted by lenders to typically secures term loan financing. This is most likely the case in States whose secured transactions regime is not up to date. However, many businesses, particularly newly-established businesses, do not own any real property and, therefore, may not have access to term-loan financing. In other States, term loans secured by movables other assets, such as equipment and even intellectual property, are common.

34. Here is an illustration of this type of financing: ABC desires to expand its operations and purchase a business in State Y. ABC obtains a loan from Lender C to

finance such acquisition. The loan is repayable in equal monthly instalments over a period of ten years and is secured by existing and future assets of ABC and the entity being acquired.

#### 4. Transfer of title for security purposes

35. In States that honour a form of transfer of ownership even when it does not entail a transfer of possession and is done for financing purposes, a transaction denominated as a transfer of title by way of security (or sometimes as a "fiduciary" transfer of title) is recognized. These transactions are essentially non-possessory security rights, and they are primarily used in States where the secured transactions law has not yet appropriately recognized non-possessory security rights.

#### 5. Sale and leaseback transactions

36. A "sale and leaseback transaction" provides a method by which a company can obtain credit based upon its existing tangibles (usually equipment) while still retaining possession and the right to use the tangibles in the operation of its business. In a sale and leaseback transaction, the company will sell its assets to a another person for a specific sum (which it may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement. Often, the lease is a "financial lease" as opposed to an "operating lease" (see para. 27 for a definition of both terms).

## II. Key objectives of an effective and efficient secured transactions regime

37. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime.

### A. Promote secured credit

38. The primary overall objective of the Guide is to promote low-cost secured credit for persons in jurisdictions that adopt legislation based on the Guide's recommendations, thereby enabling such persons and the economy as a whole to obtain the economic benefits that flow from access to such credit (see para. 2).

### B. Allow utilization of the full value inherent in assets to support credit in a broad array of credit transactions

39. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (i) permitting a broad range of assets to serve as encumbered assets (including present and future assets);

(ii) permitting a broad range of obligations (including future and conditional obligations) to be secured by security rights in encumbered assets; and (iii) extending the benefits of the regime to a broad array of debtors, creditors and credit transactions.

## C. Obtain security rights in a simple and efficient manner

40. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include: eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or actions by the parties.

## D. Recognize party autonomy

41. Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the Guide stresses the need to keep mandatory rules to a minimum so that parties may tailor their credit transactions to their specific needs. At the same time, the Guide takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

## E. Provide for equal treatment of diverse sources of credit

42. Because healthy competition among all potential creditors is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to various creditors, including banks and other financial institutions, as well as domestic and non-domestic creditors.

## F. Validate non-possessory security rights

43. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with mechanisms for publicizing the existence of such security rights.

## G. Encourage responsible behaviour on the part of all parties by enhancing predictability and transparency

44. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns.

## H. Establish clear and predictable priority rules

45. A security right will have little or no value to a creditor unless the creditor is able to ascertain, at the time a transaction takes place, its priority in the property relative to other creditors (including an insolvency representative). Thus, the Guide proposes the establishment of a system for registering public notices with respect to security rights and, based on that system, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

## I. Facilitate enforcement of creditor's rights in a predictable and efficient manner

46. A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner. Thus, the Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

## J. Balance the interests of the affected persons

47. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

## K. Harmonize secured transactions laws, including conflict-of-laws rules

48. Adoption of legislation based on the recommendations contained in the Guide will result in harmonization of secured transactions laws (through the adoption of similar substantive laws which will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade

and the movement of goods and services across national borders. Furthermore, to the extent complete harmonization of national secured transactions laws might not be achieved, conflict rules would be particularly useful to facilitate cross-border transactions. In any event, conflict-of-laws rules would be useful in order, for example, to help secured creditors determine how to make their security rights effective against third parties.