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Security rights in rights to drawing proceeds from an independent undertaking: definitions and recommendations

Note by the Secretariat

Addendum

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Security rights in rights to drawing proceeds from an independent undertaking

I. Definitions (A/CN.9/WG.VI/WP.22/Add.1, paragraph 21, (y), (z), (aa) and (bb))

(y) “Independent undertaking” means a letter of credit (commercial or standby), a letter of credit confirmation, an independent guarantee (demand, first demand, bank guarantee or counter-guarantee) or any 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 for Demand Guarantees.

(z) “Right to drawing proceeds from an independent undertaking” means the right to receive a payment due, a draft accepted or deferred payment or another item of value, in each case to be delivered by the guarantor/issuer honouring or by a nominated person giving value for, a draw under an independent undertaking. The term does not include[:] (i) the right to draw (i.e. to request payment) under an independent undertaking, or (ii) what is received upon honour of a drawing from the guarantor/issuer or nominated person or upon disposition of a right to drawing proceeds from an independent undertaking (i.e. the proceeds themselves).

[Note to the Working Group: The commentary will explain that the definition covers only the “right to receive” whatever value is paid or provided upon honour of a drawing and not the right to draw, i.e. to request payment under an independent undertaking. It will also explain that the right to receive the proceeds does not include the proceeds themselves, i.e. what is actually received upon honour of a drawing from the guarantor/issuer or nominated person (a beneficiary’s receipt of value from a negotiating bank should not be characterised as honour or disposition) or upon disposition of a right to drawing proceeds from an independent undertaking. The commentary will also highlight the distinction between the right to drawing proceeds from an independent undertaking (as an original encumbered asset) and the “proceeds” (a key concept of this Guide) of that right. The Working Group will note that the reference to the “beneficiary-grantor” has been deleted as unnecessary. This is in line with the Guide’s treatment of the term “receivable” (the Guide does not define “receivable” in terms of the grantor). Moreover, at the time of the grant, the grantor may not yet be a beneficiary, indeed, the independent undertaking may not even exist at that time. Who is entitled to receive payment is a matter of other law (in the context of receivables, for example, the Guide does not specify who is entitled to receive payment of the receivable).]

(aa) “Guarantor/Issuer” means a bank or other person that issues an independent undertaking. The term includes a bank or other person that issues a letter of credit confirmation (“confirmer”) or counter-guarantee.

(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.

(hh) “Control” with respect to a right to drawing proceeds from an independent undertaking means that the guarantor/issuer or nominated person that will pay or give value upon a draw under an independent undertaking: (i) is itself the secured creditor, or (ii) has made an acknowledgment in favour of the secured creditor. “Acknowledgment” with respect to a right to drawing proceeds from an independent undertaking means that the guarantor/issuer or the nominated person that will pay or otherwise give value upon a draw under an independent undertaking has, unilaterally or by agreement: (i) acknowledged or consented to (however evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the right to drawing proceeds from an independent undertaking, or (ii) has obligated itself to pay or give value to the secured creditor upon a draw under an independent undertaking.

[Note to the Working Group: This new definition was prepared pursuant to the request of the Working Group (see A/CN.9/588, para. 81). The commentary will include language that the definitions must be read together with all recommendations relating to independent undertakings (3 (d), 16, 25, 25 bis, 25 ter, 25 quater, 49, 62, 106, 138 and 138 bis.).]

II. Recommendations

Parties, secured obligations and assets covered (see A/CN.9/WG.VI/WP.21, recommendations 3 (d), 16 and 25)

3. In particular, the law should provide that it applies to:

(d) All types of movable assets and fixtures, tangible or intangible, present or future, not specifically excluded in the law, including inventory, equipment and other goods, receivables, negotiable instruments (such as cheques, bills of exchange and promissory notes), negotiable documents (such as bills of lading), bank accounts, rights to drawing proceeds from an independent undertaking and intellectual property rights;

Security rights in a right that secures or supports an assigned receivable, a negotiable instrument, or another obligation

16. The law should provide that upon creation of a security right in a receivable, a negotiable instrument or any other obligation covered as an encumbered asset by this Guide, a security right is automatically created, without further action by either the grantor or the secured creditor, in any personal or property right that secures or supports payment or performance of that receivable, negotiable instrument, or other obligation. However, if, under the law governing a right that secures or supports payment of a receivable, negotiable instrument or other obligation covered as an encumbered asset by this Guide, a security right in that securing or supporting right may be created only after a separate act of creation, the grantor is obligated to take such action. When an independent undertaking supports payment or performance of a receivable, a negotiable instrument or any other obligation covered as an encumbered asset by this Guide, the right to drawing proceeds from the independent undertaking is a supporting obligation under this recommendation and the security right in it is created without a separate act of creation by the grantor.

[Note to the Working Group: Recommendation 16 introduces the concept of supporting rights (which might usefully be presented as a defined term, if the Working Group so decides) and provides for automatic creation of a security right in a personal or property right that supports a receivable, a negotiable instrument or any other obligation covered as an encumbered asset by this Guide, immediately upon the creation of a security right in the supported encumbered asset. The substantive effect is to do away with the necessity for a separate act of creation with respect to the supporting obligation. While this concept does nothing that the parties cannot do expressly, it nevertheless serves a very valuable function in practice. A great many routine secured transactions involve supporting obligations and provision for this arrangement serves greatly to enhance the probability of achieving the goal of the secured transactions law to maximize credit at lower cost. In the exceptional case (if that might exist) where the parties would not wish to create a security right in a supporting obligation, that can be done by negating language in the security agreement. The Working Group has already adopted the technique of automatic creation of a security right in proceeds, without the need for express use of special wording.]

The Working Group may find it useful to consider some examples of situations involving supporting rights. An example of a supporting personal right would be a fourth-party guaranty that supports payment of a receivable that is the encumbered asset provided by a grantor (A, grantor, grants to B, secured creditor; a security right in a receivable owed to A by C, account debtor or third-party debtor; the receivable, the supported encumbered asset, is guaranteed by D; D's guaranty is the supporting personal right). An example of a supporting property right would be a security right in a piece of equipment that secures payment of a negotiable instrument that is the encumbered asset provided by a grantor (A, grantor, grants to B, secured creditor; a security interest in a negotiable instrument issued by X in favour of A; the obligation of X evidenced by the instrument, the supported encumbered asset, is secured by a security right, the supporting property right, in a piece of equipment granted to A by the owner of the equipment (who might be X or Y)).

The second sentence of recommendation 16 is intended to ensure that, if the supporting right is transferable, under the law governing it, only by way of a separate act of transfer, a separate act is required for the creation of a security right in that supporting right. This approach is consistent with the relevant law and practice, as well as with article 10 (1) of the UN Assignment Convention.

The purpose of the third sentence is to make clear that the fact that an independent undertaking is a supporting right does not mean that for the creation of a security right in a right to drawing proceeds from that independent undertaking a separate act of creation is required. In other words, the general rule of the first sentence (and not of the second sentence) is applicable.

Thus, for example, a standard commercial letter of credit typically supports a buyer's obligation to pay a commercial invoice and a standby letter of credit or demand guarantee typically supports some other payment or performance obligation of the person who procures the standby letter of credit or demand guarantee for the benefit of the beneficiary. Recognition of the supporting function served by a right to drawing proceeds from an independent undertaking (which by definition does not include the right to request payment, or the proceeds themselves)

in no way diminishes the independence of the undertaking itself and in no way adversely affects the guarantor/issuer (who is fully protected under the rules set forth in other recommendations (e.g. 25 bis, 25 ter and 25 quater).]

Creation of a security right in a right to drawing proceeds from an independent undertaking

25. The law should provide that a beneficiary may grant a security right in a right to drawing proceeds from an independent undertaking, [even if the right to draw under the independent undertaking is not itself transferable under the law that governs the independent undertaking]. The grant of a security right in a right to drawing proceeds from an independent undertaking is not a transfer of the right to draw under an independent undertaking.

[Note to the Working Group: The Working Group may wish to note that the bracketed language makes clear the important point that transferability of the undertaking itself (i.e. the right to draw) is irrelevant to the right to create a security right in the right to drawing proceeds from an independent undertaking. The second sentence distinguishes the transfer of the right to request payment under an independent undertaking from the transfer of a right to receive the proceeds from payment under an independent undertaking.]

25 bis. The law should provide that:

(a) A secured creditor's rights in a right to drawing proceeds from an independent undertaking are subject to the rights, under the law and practice that govern independent undertakings, of the guarantor/issuer or nominated person and of any other beneficiary named in the undertaking or to whom a transfer of drawing rights has been effected;

(b) The rights of a transferee- [or co-] beneficiary of an independent undertaking are superior to a security right in a right to drawing proceeds of the independent undertaking acquired from the transferor or any prior transferor; and

(c) The independent rights of a guarantor/issuer, nominated person or transferee-beneficiary [or co-beneficiary] under an independent undertaking [supersede] [are not impaired by reason of] [are distinct from] any security rights it may have in rights to drawing proceeds, including any right to drawing proceeds that may be included in a transfer of drawing rights to a transferee-beneficiary [or co-beneficiary].

[Note to the Working Group: The Working Group may wish to note that the commentary will make clear that this recommendation is intended to ensure that the rights of holders of independent rights to payment, notably nominated persons that have given value and transferee-beneficiaries to whom a transfer has been effected, are superior to mere assignees of rights to drawing proceeds from a drawing by the original beneficiary. The commentary will also explain that their independent rights are distinct and are not impaired because of their rights as secured creditors of the original beneficiary (in other terms, their status as protected holders of independent rights should not be confused with their incidental status as secured creditors). When a nominated person gives value and obtains reimbursement from the issuer, it does so on the basis of its independent reimbursement rights and not as an acquirer of the rights of the beneficiary.]

25 ter. Neither a guarantor/issuer nor a nominated person is obligated to pay any person other than a named beneficiary, an acknowledged transferee-beneficiary [or co-beneficiary], a nominated person or an acknowledged assignee of the right to drawing proceeds from an independent undertaking.

25 quater. The law should provide that, if a secured creditor has obtained control over a right to drawing proceeds from an independent undertaking by becoming an acknowledged assignee of the right, the secured creditor has the right to enforce the acknowledgement against the guarantor/issuer or nominated person that made the acknowledgement

[Note to Working Group: The Working Group may wish to note that recommendations 25 bis, 25 ter and 25 quater, which have been prepared pursuant to the request of the Working Group (see A/CN.9/588, paras. 82 and 83) and track the language of recommendation 106 (see A/CN.9/WG.VI/WP.21/Add.2), are not really about creation of security rights (or about third-party effectiveness, priority over competing claims or enforcement). However, they are included here as the recommendations on the rights and obligations of the account debtor follow the recommendations dealing with the assignment of receivables. The Working Group may wish to include these three provisions (and other similar sections dealing with the rights and obligations of account debtors, depositary banks, obligors on negotiable instruments and issuers of negotiable documents) in a separate part that addresses rights and obligations of third parties that are obligated with respect to an encumbered asset.]

Third party effectiveness of a security right in a right to drawing proceeds from an independent undertaking (see A/CN.9/WG.VI/WP.21/Add.1, recommendations 49 and 62)

49. The law should provide that a security right in a right to drawing proceeds from an independent undertaking is made effective against third parties :

(a) If the secured creditor has control of the right to drawing proceeds from an independent undertaking; or

(b) Automatically, without further action by either the grantor or the secured creditor, if a security right in the receivable, negotiable instrument or other obligation supported by the independent undertaking is effective against third parties.

[Note to the Working Group: The Working Group may wish to note that recommendation 49 has been revised on the basis of the assumption that neither possession of the independent undertaking nor registration should be a method of achieving third-party effectiveness of a security right in a right to drawing proceeds from an independent undertaking. Possession of an independent undertaking (even when it is in tangible form) plays only a limited role in the modern use of independent undertakings. In addition, if possession were included in this Guide as a method of achieving effectiveness against third parties, there would be a need for complex rules dealing with priority and conflict of laws. It should be noted, however, that, although possession does not constitute a method of achieving effectiveness against third parties, as a practical matter, possession would give protection to a secured creditor when the terms of the independent undertaking require the physical presentation of the independent undertaking to make a draw under the independent undertaking. In such a circumstance, the beneficiary could

not make an effective draw without the secured creditor's cooperation, so the secured creditor could take steps to assure itself of payment (e.g. the secured creditor could require the beneficiary to obtain an acknowledgement that would achieve control for the secured creditor before surrendering the independent undertaking and allowing it to be presented to the guarantor/issuer or nominated person that gave the acknowledgement).]

Priority of a security right in a right to drawing proceeds from an independent undertaking

62. The law should provide that a security right in a right to drawing proceeds from an independent undertaking, which has been made effective against third parties by control has, with respect to a particular guarantor/issuer or a nominated person agreeing to give value under an independent undertaking, priority over the rights of all other secured creditors who have not, with respect to that person, made their security right effective against third parties by control. If control has been achieved by acknowledgement and inconsistent acknowledgements have been given to more than one secured creditor by a person, among those secured creditors, the secured creditor who was identified in the first acknowledgement given by that person has priority.

[Note to the Working Group: The Working Group may wish to note that, as the typical method of achieving control is by obtaining an acknowledgment, in the case of several potential payors (e.g. the issuer and several nominated persons), control is achieved only vis-à-vis the particular guarantor/issuer(s) or nominated person(s) who gave the acknowledgment(s). Thus, the priority rule must focus on the particular person who is the payor. The priority rules relating to possession and registration contained in the previous draft of this recommendation (see A/CN.9/WG.VI/WP.21/Add.1, recommendation 49 (b) and (c)) were deleted since, under revised recommendation 49, possession of the independent undertaking and registration are not recognized as methods of achieving third-party effectiveness of a security right in a right to drawing proceeds from an independent undertaking. The priority rule relating to inconsistent acknowledgements (see A/CN.9/WG.VI/WP.21/Add.1, recommendation 49 (a)) has been included in the second sentence of revised recommendation 62. The basic priority rule makes clear that a secured creditor that has control of the right to drawing proceeds from an independent undertaking has priority over a secured creditor whose security right became effective against third parties automatically.]

Enforcement of a security right in a right to drawing proceeds from an independent undertaking (see A/CN.9/WG.VI/ WP.21/Add.2, recommendation 106)

106. The law should provide that after default the secured creditor with a security right in a right to drawing proceeds from an independent undertaking may exercise any remedy provided for secured creditors in this chapter. Effectiveness against third parties of a security right in a right to drawing proceeds from an independent undertaking (whether achieved by control or automatically) is not a prerequisite to enforcing the right. However, the power to enforce is, as against the guarantor/issuer, nominated person or beneficiary other than the grantor, subject to recommendations 25 bis, 25 ter and 25 quater.

[Note to Working Group: The commentary will make clear that no separate act of transfer by the grantor is necessary for the secured creditor to enforce a security right in a right to drawing proceeds from an independent undertaking when the security right is created automatically under recommendation 16. The commentary will also explain that any obligations of the guarantor/issuer or nominated person to the secured creditor are governed by recommendations 25 bis, 25 ter and 25 quater. Furthermore, the commentary will explain that recommendation 106 is not intended to disturb any pre-default arrangements agreed between the grantor and the secured creditor by which, prior to the grantor's default, the secured creditor receives the proceeds realized from collection on the right to drawing proceeds from an independent undertaking.]

Law applicable to security rights in a right to drawing proceeds from an independent undertaking (see A/CN.9/WG.VI/WP. 21/Add.5, recommendation 138)

138. The law should provide that: (i) the rights and duties of a guarantor/issuer or a nominated person that has received a request for an acknowledgement or that has or may pay or otherwise give value under an independent undertaking, (ii) the right to enforce a security right in a right to drawing proceeds from an independent undertaking against a guarantor/issuer or nominated person, and (iii) [except to the extent otherwise provided in recommendation 138 bis,] the effectiveness against third parties and the priority over the rights of competing claimants of a security right in a right to the drawing proceeds from the independent undertaking are governed, separately with respect to a particular guarantor/issuer or nominated person, by the law of the State determined as follows:

(a) If the guarantor/issuer has issued an independent undertaking or the nominated person has issued an acknowledgement that specifies that it is governed by the law of a State, the applicable law is the law of the specified State;

(b) If the applicable law is not determined under the preceding paragraph, the applicable law is the law of the State in which is located the branch or office of the guarantor/issuer or nominated person indicated in the independent undertaking of the guarantor/issuer or nominated person. However, in the case of a nominated person that has not issued an independent undertaking, the applicable law is the law of the State in which is located the nominated person's branch or office that has or may pay or otherwise give value under the independent undertaking.

[138 bis. The law should provide that[, to the extent that a security right in a right to drawing proceeds from an independent undertaking is created and is made effective against third parties automatically under recommendations 16 and 49,] the creation and the effectiveness against third parties of that security right is governed by the law of the State whose law governs the creation and the effectiveness against third parties of the security right in the supported receivable, negotiable instrument, or other obligation covered as an encumbered asset by this Guide.]

[Note to the Working Group: The commentary will explain that recommendation 138 follows the conflict-of-laws rules applicable with respect to the rights and obligations of guarantor/issuers and nominated persons. The only exception to the principle embodied in recommendation 138 is recommendation 138 bis, which appears within square brackets, for the limited issues of creation and third-party effectiveness in the cases where a security right arises or is made effective against third parties automatically.]

Each bank (or sometimes non-bank) filling one of these roles acts pursuant to the law where it is located, meaning where its relevant branch or office is located (or the law it chooses, which is typically where its relevant branch or office is located). Accordingly, different laws govern the different banks involved, and a choice of law in an independent undertaking governs only the particular issuer's obligations (see URDG article 27, UCC 5-116(b), and UN Assignment Convention article 22). The commentary will also explain that what recommendation 138 strives to do is be clear that a request for acknowledgement or for payment (without prior acknowledgement) made by a claimed secured creditor (or the beneficiary on its behalf) is to be handled by the affected bank branch under its local law. Under recommendation 138, all priority conflicts are subject to the law chosen by a guarantor/issuer or nominated person or, in the absence of a choice of law, to the law of the relevant branch or office. The Working Group may wish to consider the question whether: (i) if that bank branch pays (or gives value to) that secured creditor, then that same law should apply to that secured creditor's dispute with third parties; and (ii), if the payment is to the beneficiary and the competition is among third parties, recommendation 138 should be inapplicable and residual conflict-of-laws rules apply (i.e. recommendation 137).

The commentary will further explain that: (i) creation of the security right is governed by the general conflict-of-laws rule in recommendation 137 for security rights in intangibles (except as provided in recommendation 138 bis for automatic creation); and (ii) enforcement of the security right is governed by the general conflict-of-laws rule in recommendation 148, except to the extent otherwise provided in recommendation 138.

The Working Group may wish to consider whether recommendation 138 bis is necessary, i.e. whether the creation and the third-party effectiveness of a security right in a right to drawing proceeds from an independent undertaking should be referred to the law governing the obligation supported by the independent undertaking (i.e. the law of the grantor's location under recommendation 137 with the exception of situations covered in the second sentence of recommendations 137 and 140). In the absence of recommendation 138 bis, recommendation 137 would apply to the creation (including automatic creation) of such a security right, while recommendation 138 (i.e. the law specified in the independent undertaking or acknowledgement or, in the absence of such specification, the law of the branch of the payor) would apply to the third-party effectiveness of that right. If the Working Group decides that recommendation 138 bis is necessary, it may wish to consider whether the reference to automatic creation under recommendations 16 and 49, which appears within separate square brackets, should be retained. Retention of that reference might complicate the application of recommendation 138 bis where the State whose law is applicable under this recommendations has not adopted the substantive law recommendations of the Guide.]