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Draft Legislative Guide on Secured Transactions

Security rights in proceeds, attachments and masses or products: definitions and recommendations

Note by the Secretariat

Addendum

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* This document is submitted 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.



I. Security rights in proceeds

A. Definitions (A/CN.9/WG.VI/WP.22/Add.1, paragraph 21 (ee))

(ee) “Proceeds” means whatever is received in respect of encumbered assets. [For example, proceeds include what is received as a result of sale, or other disposition or collection, lease, licence, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects, damage or loss.]

[Note to the Working Group: The Working Group may wish to note that assets that are excluded from the scope of the draft Guide as original encumbered assets may be affected by the draft Guide if they are identifiable proceeds of assets that are within the scope of the draft Guide (e.g. securities that are proceeds of bank accounts or proceeds of independent undertakings). However, rights of parties under other law applicable to assets outside the scope of the draft Guide as original encumbered assets are not to be affected (see Note after recommendation 3 (d) in A/CN.9/WG.VI/WP.26/Add.7). The Working Group may wish to note that the definition of proceeds or recommendation 29 may need to be adjusted if recommendation 30 is retained.]

B. Recommendations

Creation of a security right in proceeds (see A/CN.9/WG.VI/WP.21, recommendations 29 and 30)

29. The law should provide that, unless otherwise agreed by the parties to the security agreement, the security right in the encumbered assets extends to the proceeds to the extent that the proceeds are identifiable in accordance with recommendations 29 bis.

29 bis. The law should provide that, when the proceeds are money, receivables or rights to payment of funds credited to a bank account that have been commingled with other property so that the proceeds are not identifiable, the [amount] [value] of proceeds immediately before they were commingled with the other property is to be treated as identifiable proceeds, provided that, at any time after the proceeds were commingled with the other property, the total [amount] [value] of the commingled property was more than the [amount] [value] of the proceeds. If, at any time after the proceeds were commingled with the other property, the total [amount] [value] of the commingled property was less than the [amount] [value] of the proceeds, the total [amount] [value] of the commingled property at the time that the [amount] [value] of the commingled property was lowest, plus the [amount] [value] of any proceeds later commingled with the commingled property, is to be treated as identifiable proceeds.]

[Note to the Working Group: The Working Group may wish to consider whether a recommendation should be prepared for identifying proceeds (“tracing”) other than money and the like. The Working Group may also wish to note that the commentary will explain how proceeds that are money, receivables or rights to

payment of funds credited to a bank account may be commingled with other property so that the proceeds cannot be separately identified.]

30. [The law should provide that, notwithstanding recommendation 29, the security right extends to civil and natural fruits of encumbered assets, such as [...], only if the parties so provide in the security agreement.]

[Note to the Working Group: The Working Group may wish to note that recommendation 30 introduces a different approach as to civil and natural fruits of encumbered assets from the approach taken in recommendation 29 with respect to other types of proceeds. However, the notion of “proceeds”, as defined in the terminology section, includes civil and natural fruits, and the natural expectation may be that the security right will extend automatically to civil and natural fruits. Thus, the Working Group may wish to consider deleting recommendation 30.]

Third party effectiveness of a security right in proceeds (see A/CN.9/WG.VI/WP.24/Add.3, recommendation 44)

41.

Alternative A

The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset is effective against third parties when the proceeds arise, provided that:

(a) The security right in the encumbered asset was made effective against third parties by registration of a notice in the general security rights registry, registration in a specialized registry or notation on a title certificate and remains effective at that time; or

[Note to the Working Group: The Working Group may wish to note that paragraph (a) would not apply, for example, to a security right which was made effective against third parties by possession. The residual rule in recommendation 41 bis would apply to such a right.]

(b) The proceeds take the form of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

41 bis. If recommendation 41 does not apply, the security right in the proceeds is effective against third parties for [...] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendations 35 or 36 before the expiry of that time period.

Alternative B

The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset is effective against third parties when the proceeds arise, provided that the proceeds take the form of money, receivables, negotiable instruments or rights to payment of funds credited to a bank account.

41 bis. If recommendation 41 does not apply, the security right in the proceeds is effective against third parties for [...] days after the proceeds arise and continuously thereafter, if it was made effective against third parties by one of the methods referred to in recommendations 35 or 36 before the expiry of that time period.

[Note to the Working Group: The Working Group may wish to note that, in view of the difference of opinion in the Working Group as to whether the right in proceeds should be automatically effective or whether a separate act of third-party effectiveness should take place when the proceeds arose (see A/CN.9/593, paras. 26-32), recommendation 41 includes two alternatives.

Under alternative A, a security right in proceeds is automatically effective against third parties, if the security right in the originally encumbered assets was made effective against third parties by registration or if the security right was in money and the like. If the security right was made effective against third parties by possession, according to recommendation 41 bis, the security right in the proceeds would be effective for a short period of time and thereafter only subject to a separate act of third-party effectiveness.

Under alternative B, automatic third-party effectiveness would be limited to proceeds in the form of money and the like, while recommendation 41 bis would apply to all other cases. As a result of this approach, a security right in proceeds would remain effective against third parties for a few days after the proceeds arose and thereafter only if a notice was registered with respect to the security right in the proceeds or by dispossession of the grantor. The commentary will clarify that civil fruits are covered by receivables, while natural fruits are automatically covered as they are defined as proceeds.

The Working Group may also wish to consider that, to balance the needs to protect a secured creditor and third parties, the time period referred to in recommendation 41 bis should be as short as the grace period in the third-party effectiveness recommendation applicable to acquisition security rights (i.e. 20-30 days, see A/CN.9/WG.VI/ WP.24/Add.5, rec. 127).]

Priority of a security right in proceeds (see A/CN.9/WG.VI/ WP.24/Add.4, recommendation 66)

67. Except as provided in the recommendations of this chapter [and the chapter on acquisition financing devices], the law should provide that a security right in the proceeds of an encumbered asset that is effective against third parties has the same priority as the security right in the encumbered asset.

[Note to the Working Group: The Working Group may wish to note that the text in square brackets may be necessary if the Working Group decides that the super-priority of an acquisition security right should not extend to proceeds in the form of receivables (see A/CN.9/WG.VI/ WP.24/Add.5, rec. 133, text in square brackets).]

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

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that the general enforcement recommendations apply to proceeds.]

Law applicable to security rights in proceeds (see A/CN.9/WG.VI/ WP. 21/Add.5, recommendation 136)

136. The law should provide that:

(a) The creation of a security right in proceeds is governed by the law [of the State whose law governs] [governing] the creation of the security right in the original encumbered asset from which the proceeds arose; and

(b) The effectiveness against third parties and the priority over the rights of competing claimants of a security right in proceeds are governed by the same law as the law [of the State whose law governs] [governing] the effectiveness against third parties and the priority over the rights of competing claimants of a security right in original encumbered assets of the same kind as the proceeds.

II. Security rights in attachments

A. Definitions (A/CN.9/WG.VI/WP.22/Add.1, paragraph 21 (l))

(l) “Attachments to immovable property” means tangibles that are so physically attached to immovable property as to be treated as immovable property without however losing their separate identity as movables under the law of the State where the immovable property is located.

[Note to the Working Group: The Working Group may wish to note that the commentary will set forth examples of attachments to immovable (e.g. air conditioner or furnace but not bricks or cement).]

“Attachments to movable property” means tangibles that are so physically attached to other movable property [as to be treated as part of that movable property], without however losing their separate identity under law other than this law.

[Note to the Working Group: The Working Group may wish to note that the commentary will set forth examples of attachments to movable property (e.g. tires, aircraft engines).]

B. Recommendations

Creation of a security right in attachments (see A/CN.9/WG.VI/WP.21, recommendation 31)

31. The law should provide that a security right may be created in tangibles that are attachments at the time of creation of the security right or continue in tangibles that become attachments subsequently. Security rights in attachments to immovable property may be created under this law or law on immovable property.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that, if the security right in attachments to immovable property is created under the law of immovable property, the security right may be at the same time effective against third parties. The commentary will also explain that, if such a security right is created under the secured transactions law, rights of persons that have rights under immovable property law may not be affected. For example, a security right created under secured transactions law may be enforced only if there are no competing rights created under immovable property law or the former security right has priority over competing rights acquired under immovable property law (see recommendation 83).]

Third party effectiveness of a security right in attachments (see A/CN.9/WG.VI/WP.24/Add.3, recommendations 45 and 46)

45. The law should provide that a security right in a tangible that is an attachment at the time it is made effective against third parties or becomes an attachment only subsequently may be made effective against third parties by registration of a notice in the general security rights registry. The law should also provide that, if a security right in a tangible is effective against third parties at the time when the tangible becomes an attachment, the security right remains effective against third parties thereafter.

46. A security right in an attachment to immovable property may also be made effective against third parties by registration in the immovable property registry.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that recommendation 46 is designed to protect the integrity and reliability of the immovable property registry. This recommendation is supplemented by recommendation 83 in A/CN.9/WG.VI/WP.24/Add.4, under which a security right in tangibles that are or are to become attachments to immovable property, which became effective against third parties by registration of a notice in the immovable property registry under recommendation 45 has priority over a security right in the related immovable that was registered subsequently.]

The commentary will also explain that, if a security right in an attachment to immovable property is made effective against third parties under this recommendation, what is registered is, in principle, a matter of immovable property law. However, the attention of the legislator may have to be drawn to the need to amend immovable property law so as to permit registration of a notice about a security right rather than only notarial documents. One difficulty in third parties finding that notice is that registration in the immovable property registry is made against the asset and not the grantor.

The commentary will further explain that the security right will be in the immovable property as a whole but the notice should describe the attachment and priority should be limited to the value of the attachment, if it were detached. The question whether the attachment could be detached and how the secured creditor would be paid would also need to be addressed as a matter of enforcement (see recommendation in enforcement below). The Working Group may wish to consider whether a creditor with a right acquired under immovable property law should have a right to pay off the debt owed to the secured creditor with a security right acquired under movable property law. This matter may be left to inter-creditor agreements.]

Third-party effectiveness of a security or other right in attachments to movables subject to a specialized registration system or title certificate system

46 bis. A security right or any other right (such as the right of a buyer or lessor) in an attachment to movable property that is subject to registration in a specialized registry or a title notation system may also be made effective against third parties by such registration or notation.

Priority of a security or other right in attachments to immovable (see A/CN.9/WG.VI/WP.24/Add.4, recommendations 82 and 83)

82. The law should provide that a security right or any other right (such as the right of a buyer or lessor) in attachments to immovable property that has been created and made effective against third parties under immovable property law has priority over a secured creditor with a security right in those attachments that has been made effective against third parties by one of the methods referred to in recommendations 35 or 36.

83. A security right in tangibles that are attachments to immovable property at the time the security right is made effective against third parties or that become attachments to immovable property subsequently, which was made effective against third parties by registration in the immovable property registry under recommendation 46 has priority over a security right or any other right (such as the right of a buyer or lessor) in the related immovable that was registered subsequently.

[Note to the Working Group: The Working Group may wish to consider recommendation 83 together with the relevant recommendation in the chapter on acquisition financing devices (see A/CN.9/WG.VI/WP.24/Add.5, recommendation 130 ter. The commentary will explain that the words “any other right” refers to any right registrable in the immovable property law.]

Priority of a security or other right in attachments to movable property subject to a specialized registration system or title certificate system (see A/CN.9/WG.VI/WP.24/Add.4, recommendations 84 and 85(a))

84. The law should provide that a security right or any other right (such as the right of a buyer or lessor) in attachments to movable property that has been created and made effective against third parties under other law by registration in a specialized registry or by notation on a title certificate has priority over a security right or any other right in those attachments that has been made effective against third parties by one of the methods referred to in recommendations 35 or 36.

84 bis. A security right or any other right in tangibles that are attachments to movable property at the time the security right is made effective against third parties or that are to become attachments to movable property subsequently, which was made effective against third parties by registration in a specialized registry or by notation on a title certificate under recommendation 46 bis has priority over a security right or any other right in the related movable property that was registered subsequently.

[Note to the Working Group: The Working Group may wish to note that recommendations 84 and 84 bis track the language of recommendations 82 and 83. The only difference is that recommendations 84 and 84 bis deal with assets that are within the scope of the draft Guide (e.g. automobile engines).]

Enforcement of a security right in attachments (see A/CN.9/WG.VI/WP.24/Add.1)

[Note to the Working Group: The Working Group may wish to consider that the general recommendations apply to the enforcement of a security right in attachments to movable property. As to the enforcement of security rights in

attachments to immovable property, the Working Group may wish to consider an additional recommendation along the following lines:

“The law should provide that the secured creditor with a right in an attachment to immovable property (e.g. an elevator) that has priority can enforce its right in the attachment (not in the immovable property). A creditor with a security right in the immovable is entitled to pay off the debt of the creditor with a security right in the attachment (as a general rule, junior creditors should have this right). The creditor with a security right in the attachment has to pay damages for any damage caused by the act of removal of the attachment from the immovable (not the diminution value). If the creditor with a security right in the attachment does not have priority, it cannot enforce-detach (although this may be an issue of valuation that arises generally in the case of enforcement by the junior creditor with a right in part of an asset). If the creditor with a security right in the attachment has an acquisition security right, it has the super-priority provided under recommendation 130, except as against a construction lender who is financing all construction (this rule is part of construction law, see A/CN.9/WG.VI/WP.24/Add.5, rec. 130 ter).”]

Law applicable to security rights in attachments (see A/CN.9/WG.VI/WP.21/Add.5)

[Note to the Working Group: The Working Group may wish to consider that recommendation 136 is sufficient with respect to the law applicable to the creation, third-party effectiveness and priority of a security right in an attachment to movable property, while recommendation 148 is sufficient for the enforcement of a security right in an attachment to movable property. As to the law applicable to the enforcement of a security right in an attachment to immovable property, the Working Group may wish to include an additional recommendation along the following lines: “The enforcement of a security right in an attachment to immovable property is governed by the law of the State where the immovable property is located.”]

III. Security rights in masses or products

A. Definitions (A/CN.9/WG.VI/WP.22/Add.1, paragraph 21 (l))

(l) “Mass or product” means tangibles other than money that are so physically associated or united with each other that they lose their separate identity under law other than this law.

[Note to the Working Group: The Working Group may wish to note that the commentary will give examples of masses or products (e.g. product: cake produced from sugar, eggs, flower and water. Mass: grain in a silo or oil in a tank).]

B. Recommendations

Creation of a security right in a mass or product (see A/CN.9/WG.VI/WP.21, recommendation 32)

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that a security right may not be created in tangibles that are part of a mass or product as, at the time of creation of the security right, they do not exist as separate tangibles.]

32. The law should also provide that a security right in tangibles that become part of a mass or product after the creation of a security right, continues in the mass or product. [The security right is limited to the value of the tangibles immediately before they became part of the mass or product.]

[Note to the Working Group: The Working Group may wish to note that the second sentence is within square brackets as the valuation issue may be an issue of priority rather than creation. Under this approach, if the value of the flour is 5 and the value of the sugar is 5, while the value of the cake is 20 and there are two secured creditors, each secured creditor will get 5, while the remaining value of 10 will be preserved for the grantor and its unsecured creditors. If the value of the cake is lower than the value of the ingredients, the secured creditors will share the loss proportionately (e.g. if the value of the cake is 8, each secured creditor will get 4). This means that: (i) the security right is still a security right in the separate tangible and the secured creditor cannot get more than owed, (ii) if the value of the mass or product is less, the secured creditor will suffer a proportionate diminution (this is a priority issue), and (iii) the dates of creation do not affect priority.]

Third party effectiveness of a security right in a mass or product (see A/CN.9/WG.VI/WP.24/Add.3, recommendation 47)

47. The law should provide that, if a security right in a tangible is effective against third parties at the time when it becomes part of a mass or product, the security right in the mass or product created as provided in recommendation 32 is effective against third parties thereafter [without the need for any further act] [for [...] days after the mass or product is created, and continuously thereafter if it was made effective against third parties by one of the methods referred to in recommendations 35 or 36 before the expiry of that time period.]

Priority of a security right in a mass or product (see A/CN.9/WG.VI/WP.24/Add.4, recommendation 85)

[Note to the Working Group: The Working Group may wish to note that priority contests between creditors with security rights in property that becomes part of a mass or product and unsecured creditors require no special treatment since the regular priority rules apply once it is determined that the security right continues into the mass or product. There are, however, three types of potential priority contests between creditors each of whom has a security right with respect to the resulting mass or product: (i) contests between security rights taken in the same tangibles that ultimately become part of a mass or product (e.g. sugar and sugar), (ii) contests involving security rights in different tangibles that ultimately become part of a mass or product (e.g. sugar and flower) and (iii) contests involving a

security right originally taken in the separate tangibles and a security right in the mass or product (e.g. sugar and cake). In order to deal with all these situations recommendation 85 has been reformulated in three parts. It should be noted that, as a general matter, priority contests arise only when there is not enough value to satisfy all claims.]

85. The law should provide that a security right in the same separate tangibles that continues in a mass or product as provided in recommendation 32 and that is effective against third parties as provided in recommendation 47 has the same priority in relation to other security rights granted in the separate tangibles immediately before the tangibles became part of the product or mass. A secured creditor may not receive an amount greater than the obligation secured by its security right.

[Note to the Working Group: The Working Group may wish to note that the effect of the first sentence of this recommendation is to treat all security rights in tangibles that becomes commingled as having the same priority vis-à-vis each other as they had in the separate property. The rationale for this suggested rule is that the incorporation of goods into a mass or product should have no bearing on the respective rights of creditors with competing security rights in the separate goods. The Working Group may wish to note that the rule is framed to respect both the general priority rules and to cover the super-priority afforded to creditors who may claim “acquisition security rights”. The second sentence essentially repeats the rule stated (in somehow different formulation) in the second sentence of recommendation 32. The Working Group may wish to consider which formulation is preferable and whether the rule should be stated in both the creation and the priority recommendations.]

85 bis. The law should provide that, if (i) more than one security right in separate tangibles continues in the same mass or product as provided in recommendation 32 and each security right is effective against third parties as provided in recommendation 47, and (ii) the obligations secured by such security rights cannot all be satisfied from those security rights, the secured creditors are entitled to share in the value of their security rights in the mass or product according to the ratio of the value of the separate tangibles immediately before they became part of the mass or product. A secured creditor may not receive an amount greater than the obligation secured by its security right. If there is only one other security right, the secured creditor with respect to that other security right is entitled to the remainder of the value of its security right in the mass or product. If there is more than one other security right, the secured creditors with respect to those other security rights are entitled to share in the remainder of the value of their security rights in the mass or product in the ratio described above.

[Note to the Working Group: The Working Group may wish to note that, according to recommendation 85 bis, if the value of the sugar is 2 and the flower 5, while the value of the cake is 6 and the amount of the secured obligation 7, the creditors will receive 2/7 and 5/7 of 6. In any case, if the value of the mass or product is less than the amount of the secured obligations, there will be no value left for unsecured creditors.]

85 ter. The law should provide that a security right in separate tangibles that continues in a mass or product as provided in recommendation 32 and that is

effective against third parties as provided in recommendation 47 has priority over a security right granted by the same debtor in the mass or product, if it is an acquisition security right. A secured creditor may not receive an amount greater than the obligation secured by its security right.

[Note to the Working Group: The Working Group may wish to note that the effect of the first sentence of this recommendation is to apply the general priority rules. Security rights in initial property have priority over all security rights in the mass or product that have been taken so as to cover future property, only if the former are acquisition security rights.]

Enforcement of a security right in a mass or product

[Note by the Working Group: The Working Group may wish to consider that the general enforcement rules should apply to the enforcement of a security right in assets that become part of a mass or product. For example, if the encumbered assets are oil of value 5 in a tank with oil worth 100, the secured creditor should be able to enforce its right only in oil of value 5. If the encumbered asset can be separated the secured creditor should be able to dispose of that part only in a commercially reasonable manner. If the encumbered asset cannot be easily separated, the whole mass or product may have to be sold.]

Law applicable to a security rights in a mass or product

[Note to the Working Group: The Working Group may wish to consider whether the law governing security rights in tangibles that become part of a mass or product should be the general rule applicable with respect to security rights in tangibles (i.e. rec. 136) or the rule applicable to security rights in proceeds (i.e. rec. 141). If rec. 136 applied and the sugar component was in country X, while the cake was in country Y, the law applicable would be the law of country Y (subject to the exceptions for mobile goods and export goods). If rec. 141 applied, the law of country Y would govern creation of the security right, while the law of country Y would govern third-party effectiveness and priority. The difference between these two approaches is only about the law governing creation (i.e., law of country X or Y).]

Movables by anticipation and crops

[Note to the Working Group: The draft Guide provides that it is possible to take a security right in attachments either under the draft Guide or under applicable law governing security in immovable property. Similar issues arise in respect of (i) crops, whether renewable (e.g. as apples), annual (e.g. grain crops) or harvested (e.g. timber), (ii) products extracted from the ground (e.g. minerals, hydrocarbons, water, sand, gravel, sod), and (iii) materials that were returned to the status of movables as a result of their removal from a building being demolished or otherwise.

It is always possible to take a security right in each of these assets as future property, with creation of the security right occurring only once the property becomes movable. In such cases, there can never be a priority contest between a security right in the immovable created under other law and a security right in the

movable created under the draft Guide, since the security right in the immovable will terminate as soon as the asset becomes mobilized.

Nonetheless it is possible to imagine a regime, like that applicable to attachments, that permits the creation of a security right in movables, which is immediately effective, even while the property remains an immovable. Such a regime would have the advantage of permitting, for example, separate crop financing or financing of extractive industries separate from the financing of the farm or the mining operation.

If the Working Group decides that the draft Guide should include such a regime, additional recommendations should be prepared to address: (i) priority contests between security rights taken in immovable property acquired under other law and security rights in movable property acquired under the draft Guide, (ii) the conditions under which creditors with security rights under the draft Guide may enforce them and the enforcement rights they may exercise, and (iii) the steps that must be taken by the creditor of a security right under the draft Guide in order to make the security right effective as against a creditor with a security right in the immovable property.]