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Draft Security Rights Registry Guide

Note by the Secretariat

Contents

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Background information

At its forty-second session (Vienna, 29 June-17 July 2009), the Commission noted with interest the future work topics discussed by Working Group VI at its fourteenth and fifteenth sessions (A/CN.9/667, para. 141, and A/CN.9/670, paras. 123-126). At that session, the Commission agreed that the Secretariat could hold an international colloquium early in 2010 to obtain the views and advice of experts with regard to possible future work in the area of security interests.[1] In accordance with that decision,[2] the Secretariat organized an international colloquium on secured transactions (Vienna, 1-3 March 2010). At the colloquium several topics were discussed, including registration of security rights in movable assets, security rights in non-intermediated securities, a model law on secured transactions, a contractual guide on secured transactions, intellectual property licensing and implementation of UNCITRAL texts on secured transactions. The colloquium was attended by experts from governments, international organizations and the private sector.[3]

At its forty-third session (New York, 21 June-9 July 2010), the Commission considered a note by the Secretariat on possible future work in the area of security interests (A/CN.9/702 and Add.1). The note discussed all the items discussed at the colloquium. The Commission agreed that all issues were interesting and should be retained on its future work agenda for consideration at a future session on the basis of notes to be prepared by the Secretariat within the limits of existing resources. However, in view of the limited resources available to it, the Commission agreed that priority should be given to registration of security rights in movable assets.[4]

In that connection, it was widely felt that a text on registration of security rights in movable assets would usefully supplement the Commission's work on secured transactions and provide urgently needed guidance to States with respect to the establishment and operation of security rights registries. It was stated that secured transactions law reform could not be effectively implemented without the establishment of an efficient publicly accessible security rights registry. It was also emphasized that the *UNCITRAL Legislative Guide on Secured Transactions* (the "*Guide*") did not address in sufficient detail the various legal, administrative, infrastructural and operational questions that needed to be resolved to ensure the successful implementation of a registry.[5]

The Commission also agreed that, while the specific form and structure of the text could be left to the Working Group, the text could: (a) include principles, guidelines, commentary, recommendations and model regulations; and (b) draw on the *Guide*, texts prepared by other organizations and national law regimes that have introduced security rights registries similar to the registry recommended in the *Guide*. After discussion, the Commission decided that the Working Group should be

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[1] *Official Records of the General Assembly, Sixty-fourth session, Supplement No. 17* (A/64/17), paras. 313-320.

[2] Ibid.

[3] For the colloquium papers, see www.uncitral.org/uncitral/en/commission/colloquia/3rdint.html.

[4] Ibid., *Sixty-fifth session, Supplement No. 17* (A/65/17), paras. 264 and 273.

[5] Ibid., para. 265.

entrusted with the preparation of a text on registration of security rights in movable assets.[6]

At its eighteenth session (Vienna, 5-10 November 2010), the Working Group considered a note by the Secretariat entitled "Registration of security rights in movable assets" (A/CN.9/WG.VI/WP.44 and Addenda 1 and 2). At the outset, the Working Group expressed its broad support for a text on the registration of security rights in movable assets, noting that empirical evidence clearly demonstrated that the efficacy of a secured transactions law depended on an effective registration system (see A/CN.9/714, para. 12). As to the specific form and structure of the text to be prepared, the Working Group adopted the working assumption that the text would be a guide on the implementation and operation of a registry of security rights in movable assets that could include principles, guidelines, commentary and possibly model regulations. The Working Group also agreed that the text of the proposed registry guide should be consistent with the type of secured transactions legal regime contemplated by the *Guide*, while also taking into account the diverse approaches taken by modern national and international registry regimes. It was also observed that, in line with the *Guide* (see recommendation 54, subpara. (j)), the proposed registry guide should take into account the need to accommodate a hybrid electronic/paper system in which parties would have the option of submitting registration and search inquiries either electronically or in paper form (A/CN.9/714, para. 13). The Secretariat was asked to prepare a draft of the proposed registry guide based on the discussions and conclusions of the Working Group (A/CN.9/714, para. 11). The text that follows constitutes the first draft.

[*Note to the Working Group: The Working Group may wish to consider whether the proposed registry guide would be a stand-alone text or a supplement to the* Guide (on Secured Transactions)*. In view of the decision made by the Working Group at its eighteenth session that the background secured transactions law for the proposed registry guide will be the law recommended in the* Guide*, it would seem that the proposed registry guide should take the form of a supplement to the* Guide*. However, calling the proposed registry text a "guide" may highlight its importance, raising its profile, and be also justified on the ground that the proposed registry guide will not only elaborate on issues already addressed in the* Guide *but also address new issues (always in line with the law recommended in the* Guide*). If the Working Group decides to call the proposed registry text a "guide" rather than a "supplement" to the* Guide [on Secured Transactions]*, it may wish to consider its title (for example, Security Rights Registry Guide, Guide on the Implementation of a Security Rights Registry, etc.). While a final decision on this issue may be made at a later stage, the adoption of a working assumption at this stage would facilitate the drafting of the text.*]

[6] Ibid., paras. 266-267.

I. Introduction

A. General

1. The *UNCITRAL Legislative Guide on Secured Transactions* (the "*Guide*") reflects the global recognition of the economic importance of a modern legal framework to support financing against the security of movable assets. The establishment of a publicly accessible registry in which information about the potential existence of security rights in movable assets may be registered is an essential feature of the law recommended in the *Guide* and of reform initiatives in this area generally.

2. Chapter IV of the *Guide* contains commentary and recommendations on many aspects of a security rights registry. However, in order to understand the requirements and legal effects of registration, as well as the scope of the registry, a reader needs to have a rather thorough understanding of the *Guide* as a whole. Thus, chapter II of the draft Security Rights Registry Guide (the "draft Registry Guide") offers an integrated concise summary of the legal function of a security rights registry for States that have adopted or wish to adopt a legislative framework for secured lending along the lines of that recommended in the *Guide*. Chapter II is intended to assist not only those involved in the registry implementation process, who are not legal experts but who will need to have a basic understanding of the legal context of the registry in order to carry out their work knowledgeably, but also the registry clientele and others (see para. 10 below).

3. A general security rights registry differs fundamentally from the kinds of registry for recording title and encumbrances on title in immovable property and high-value equipment, such as ships, with which many States are most familiar. Thus, chapter III of the draft Registry Guide explains the key characteristics of a general security rights registry, notably notice registration for the purpose of establishing third-party effectiveness and grantor-based indexing, that mark it apart from other types of registry and contribute to its efficient operation.

4. The statutory framework governing secured transactions typically leaves the detailed rules applicable to the registration and search process to be dealt with in subordinate regulations, ministerial guidelines and the like. Although chapter IV of the *Guide* provides recommendations on the general policy issues associated with these legal issues, chapter IV of the draft Registry Guide (see A/CN.9/WG.VI/WP.46/Add.1 and 2) provides concrete guidelines on the types of legal rule for submitting notices for registration and conducting searches that must be drafted as part of the implementation process. These guidelines are further supplemented by draft model regulations (see A/CN.9/WG.VI/WP.46/Add.3).

5. Chapter IV of the *Guide* does not address, or does not address in every detail, the myriad of technological, administrative, and operational issues involved in developing and running an effective and efficient security rights registry. Thus, chapter V of the draft Registry Guide (see A/CN.9/WG.VI/WP.46/Add.2) seeks to complement the *Guide* by addressing these practical issues in a more specific and expanded fashion.

B. Sources

6. The experience of States that have instituted the kind of general security rights registry contemplated by the *Guide* demonstrates how advances in computer technology can vastly improve the efficiency of operation of security rights registries. Thus, particularly in relation to the technical aspects of registry design and operation, the draft Registry Guide draws on these national precedents to provide guidance to States.

7. In addition, the draft Registry Guide has benefitted from other international sources, including the following:

(a) The European Bank for Reconstruction and Development (EBRD) Publicity of Security Rights: Guiding Principles for the Development of a Charges Registry (2004);

(b) EBRD Publicity of Security Rights: Setting Standards (2005);

(c) The Asian Development Bank (ADB) Guide to Movables Registries (2002);

(d) The Principles, Definitions and Model Rules of a European Private Law, Draft Common Frame of Reference (DCFR), volume 6, book IX (Proprietary security in movable assets), chapter 3 (Effectiveness as Against Third Parties), section 3 (Registration), (2010), prepared by the Study Group on a European Civil Code and the Research Group on EC Private Law (Acquis Group);

(e) The Organization of American States (OAS) Model Registry Regulations under the Model Inter-American Law on Secured Transactions (October 2009);

(f) The International Finance Corporation (World Bank) Secured Transactions Systems and Collateral Registries (January 2010);

(g) The Organisation pour l' Harmonisation du Droit des Affaires en Afrique (OHADA) Treaty: recent developments in relation to the establishment of a regional security rights registry; and

(h) The Convention on International Interests in Mobile Equipment (Cape Town, 2001) and its Protocols, establishing international registries (which, although they are asset based and cover other transactions in addition to secured transactions, are notice based, with registration resulting in third-party effectiveness and priority).

8. The national, regional and international sources referred to above do not always accord with the recommendations in chapter IV of the *Guide* on registration-related issues. Consequently, the draft Registry Guide explains the policy rationale for approach recommended in the *Guide* relative to other possible approaches.

C. Guiding principles

9. The draft Registry Guide is informed by the following overarching principles:

(a) Legal efficiency: the legal and operational guidelines for all registry services, including but not limited to registration and searching, should be simple, clear and certain;

(b) Operational efficiency: all registry services, including the registration and search process, should be designed to be as fast and inexpensive as possible to ensure the security and accuracy of the information entered in the registry record; and

(c) A balanced approach to the interests of all registry constituents: grantors, potential secured and unsecured creditors, as well as potential competing claimants, all have an interest in the extent and scope of information that is published in a security rights registry and in the efficient availability of that information; thus, the legal and operational framework of the registry should be designed to fairly balance the interests of all its potential constituents.

D. Intended readership

10. The potential readership of the draft Registry Guide comprises all those who are interested or actively involved in the design and implementation of a security rights registry as well as those who may be affected by its establishment, including:

(a) Registry system designers, including technical staff charged with the preparation of design specifications and fulfilling of the hardware and software requirements for the registry;

(b) Registry administrators and staff;

(c) Registry clientele, credit providers, credit reporting agencies and insolvency representatives, as well as all members of the public whose legal rights may be implicated by market transactions involving movable assets potentially subject to a security right;

(d) The general legal community (including judges, arbitrators and practicing lawyers); and

(e) All involved in secured transactions law reform and law reform assistance (such as the World Bank, the EBRD, the ADB and the Inter-American Development Bank).

11. Not all of these potential readers will be versed in the intricacies of secured transactions law or even have legal training. Accordingly, the draft Registry Guide is formulated in "plain language" style employing "reader-friendly" aids.

12. Like the *Guide*, the draft Registry Guide has been formulated in a fashion that enables it to be used in States with diverse legal traditions. Consequently, to the extent that the draft Registry Guide provides model regulations, it uses neutral generic terminology that is consistent with the terminology used in the *Guide* and can be adapted readily to each State's domestic legal tradition and drafting style, as well as to local legislative conventions regarding which types of rule must be

incorporated in principal legislation and which may be left to subordinate regulations or ministerial or administrative guidelines.

13. For example, the *Guide* uses the term "notice" in the sense of a communication so as to cover not only a form (or screen) used to transmit information to the registry (see the term notice in the introduction to the *Guide*, sect. B, recommendations 54, subpara. (b), and 57) but also other communications, such as those made in the context of enforcement (see recommendations 149-151). Chapter IV of the *Guide* supplements the meaning of the term "notice" in a registration context by referring to: (a) "information contained in a notice" or "the content of the notice" (see recommendations 54, subpara. (d), and 57); and (b) the "registry record" in the sense of information contained in a notice once this information has been accepted by the registry and entered into the database of the registry that is available to the public (see recommendation 70). The draft Registry Guide uses these terms in the same sense, emphasizing more the information contained in the paper or electronic communication rather than the medium of communication.

II. Purpose of a security rights registry

A. Introduction

14. A general security rights registry of the kind contemplated in the *Guide* permits the registration of information contained in notices with respect to potential present and future security rights for the purpose of: (a) making the security rights effective against third parties; (b) providing an efficient point of reference for priority rules based on the time of registration; and (c) functioning as an objective source of information for third parties dealing with a grantor's assets (see purpose section of chap. IV of the *Guide*).

15. The term "registration of a notice" describes a procedure. Typically, in a paper context, there are three steps: (a) the submission of information in a notice by a registrant; (b) the entry of the information in a notice into the registry record and assignment of a date and time to the notice by the registry; and (c) the entry of the relevant information from the notice into the registry index by the registry at which time the information in the notice becomes available to searchers. In an electronic context, all three steps may take place simultaneously at the time the registrant completes the registration. In some States, the registration is effectively registered when the second step is completed, that is, when the notice is submitted to and received by the registry. The *Guide* recommends a different approach in that it requires information in a notice to be available to searchers of the registry record for the registration to be effective (see recommendation 70).

16. A security rights registry does not exist in a vacuum. It is an integral component of the overall legal and economic context of the secured financing regime in a particular State. Yet those who are involved in the design and implementation of a security rights registry, as well as the potential registry clientele, may not be familiar with the intricacies of secured transactions. Accordingly, this chapter provides an overview of secured transactions and the legal

function of registration within a legislative framework for secured transactions along the lines of the law recommended in the *Guide*.

B. Function of a security right

17. Although the legal terminology may vary (for example, "pledge", "charge", "security interest" or "hypothec"), the basic idea of a security right is much the same everywhere. A security right is a type of property right (right *in rem*, distinct from ownership and personal rights) given to a creditor to secure payment of a loan or other obligation (see the term "security right" in the introduction to the *Guide*, sect. B). A security right mitigates the risk of loss resulting from a default in payment by entitling the secured creditor to claim the value of the assets encumbered by the security right as a back-up source of repayment. For example, if a business that borrows funds on the security of its equipment fails to repay the loan, its secured creditor will be entitled to obtain possession of the equipment and have it disposed of in order to pay off the outstanding balance. The central feature of a security right is that it generally enables a creditor to claim the value of encumbered assets by preference over other competing claimants. As the risk of loss from default is mitigated, the ability of a person ("grantor"; see the term "grantor" in the introduction to the *Guide*, sect. B) to grant a security right expands access to credit for grantors that might not be able to obtain financing on an unsecured basis or enables credit to be obtained on more favourable terms (for example, the interest rate may be lower, the amount of the credit may be higher and the repayment period may be longer).

18. A security right is created by a contract (security agreement) in which the grantor of the security right consents to have specified assets stand as security for a specified obligation. Sometimes, the specified obligation is a loan; sometimes it is a credit facility, such as a line of credit typically offered by financial institutions. In other instances, it may be an extension of credit to finance the acquisition of tangible assets by the grantor. For example, a seller may take a security right or reserve ownership in assets sold on credit in order to secure payment of the purchase price (for acquisition financing, see the *Guide*, chap. IX; see also paras. 27, 38 and 39 below).

C. Reasons for secured credit

19. Commercial enterprises (in particular small and medium-sized enterprises) typically require some form of financing to support their start-up and expansion costs and to acquire or produce the equipment, inventory and services from which they hope to generate profits. Consequently, credit performs an important role in financing productive business development. Consumers as well may require access to credit to be able to acquire assets such as household appliances or motor vehicles. As already mentioned, a creditor that is forced to rely solely on a borrower's promise to repay is likely to extend only a small amount of credit for a short period of time, at a high interest rate and then only to a borrower that has an established credit record. Security tends to enhance access to credit at lower cost and for a longer duration because of the additional protection it offers financiers against the risk of default in payment. Indeed, many consumers and small and medium-sized

businesses are unable to access credit at all unless they have assets to offer as security (see introduction to the *Guide*, paras. 1-11).

D. Possessory and non-possessory security rights

20. Legal systems have long recognized security rights in the form of the classic possessory pledge in which the grantor delivers physical possession of the encumbered asset to the secured creditor (see the *Guide*, chap. I, paras. 51-59). The requirement for delivery of physical possession means that the secured creditor can be confident that the grantor has not already encumbered the asset in favour of another creditor and enables the secured creditor to guard against damage to or deterioration in the value of the asset. Dispossession of the grantor also alerts potential buyers and other competing claimants that the grantor no longer has unencumbered title to the asset.

21. However, possessory pledges are possible only if the asset is capable of physical possession. This excludes many types of movable asset, including future assets (that is, assets acquired by the grantor or produced after the creation of a security right; see the *Guide*, chap. I, para. 8), as well as intangible assets, such as receivables and intellectual property rights. Giving up possession may defeat the purpose of the financing. An enterprise needs to retain possession of its equipment, inventory and other business assets in order to generate the income to pay the secured obligation. Similarly, postponement of delivery of tangible assets purchased on secured credit terms would deprive consumers of the present benefit of use and enjoyment of the assets. Even when delivery of possession is feasible, the secured creditor normally will not be in a position or wish to store, maintain and insure bulky assets (for a discussion of the advantages and disadvantages of possessory pledges, see the *Guide*, chap. I, paras. 51-59).

22. In view of the limitations of possessory security, modern secured transactions laws generally permit security to be granted without the need for a delivery of physical possession of the encumbered asset to the secured creditor. A legal regime that recognizes non-possessory security rights tends to increase access to credit by expanding the range of assets that a business can offer as security. An enterprise can encumber its intangible assets in addition to its tangible assets, and its future assets (most significantly, its receivables and its inventory) in addition to its present assets. This is the approach recommended in the *Guide* (for assets that may be subject to a security right, see recommendations 2 and 17; in particular for security rights in all assets of a grantor, see the *Guide*, chap. II, paras. 61-70). Non-possessory security also enhances consumer access to credit since it enables the consumer to take immediate possession of assets purchased with a loan or credit facility.

E. A registry as a way to address legal risks of non-possessory security rights

23. It is inherent in the economic concept of a security right as a property right that the secured creditor has the right in the event of the grantor's default to claim the value of the encumbered asset in preference to the claims of competing claimants (see the terms "security right", "competing claimant" and "priority" in the

introduction to the *Guide*, sect. B). However, the recognition of non-possessory security rights poses information challenges for third parties. It is important for potential buyers or secured creditors to be aware of whether assets in a person's possession are subject to a prior security right. It is equally important for unsecured creditors and the grantor's insolvency representative to be able to determine which of the grantor's assets are already encumbered and therefore potentially not available to satisfy their claims. In the face of these information challenges, legal systems may be reluctant to permit the holder of a non-possessory security right to pursue its security right against competing claimants that acquire a right in the encumbered asset without an opportunity to become aware of the existence of the security right. On the other hand, the value of a security right to a creditor is diminished or eliminated to the extent that rules protecting third parties enable them to take their rights in the encumbered assets free of any pre-existing security right.

24. The establishment of a security rights registry enables States to resolve the "information" problem posed by non-possessory security rights in a manner that protects the rights of both secured creditors and third parties. If registration is made a condition of the effectiveness of a security right against competing claimants, third parties can protect themselves by searching the registry in advance of dealing with the grantor's assets. Priority rules based on time of registration then work to assure secured creditors that, if they register in time, their security rights will be effective against subsequent competing claimants. The legislative framework for secured transactions recommended in the *Guide* generally provides such temporal priority rules, subject only to a small number of exceptions.

25. To achieve these benefits, the establishment of a general security rights registry must follow a supportive legal framework along the lines recommended in the *Guide*. In particular, the secured transactions law under which the registry is established will need to incorporate the three basic rules of a registry-based secured transactions law such as the one recommended in the *Guide*. First, registration must be a generally available mechanism to achieve the effectiveness of a non-possessory security right against third parties (see recommendations 29 and 32). Second, in the event of the grantor's default, the holder of a security right that became effective against third parties must be entitled as against competing claimants to enforce its security right and apply the value of the encumbered asset to the outstanding part of the secured obligation (see the term "priority" in the introduction to the *Guide*, sect. B, and recommendations 142 and 152). Third, priority among security rights in the same asset that became effective against third parties by registration must be generally determined by the order of registration (see recommendation 76, subpara. (a)). Although these rules represent the baseline rules, a modern secured transactions law along the lines recommended in the *Guide* will invariably recognize some qualifications in the interest of facilitating other policy objectives. The next section offers some typical examples.

F. Exceptions to registration-based third-party effectiveness and priority rules

1. Possessory security rights

26. Although most secured transactions involve non-possessory security rights, the possessory pledge is still commonly used for certain types of asset, such as luxury non-intermediated personal items, negotiable instruments, negotiable documents and certificated securities. States that have implemented a registry system almost invariably permit taking actual possession as an alternative to registration as a means of achieving third-party effectiveness of a security right in assets capable of physical possession (not non-actual possession described by terms such as constructive, fictive, deemed or symbolic possession; see the term "possession" in the introduction to the *Guide*, sect. B). This is the approach recommended in the *Guide* (see recommendation 37). The dispossession of the grantor is considered to be sufficient practical notice to third parties that the grantor's title is unlikely to be unencumbered. In the event a possessory security right comes into competition with a security right made effective against third parties by registration, priority is generally determined by the respective order of registration or delivery of possession (see recommendation 76, subpara. (c)). However, with respect to certain types of asset, such as negotiable instruments, negotiable documents or certificated non-intermediated securities, a security right made effective against third parties by possession has priority even over a previously registered security right (see recommendations 101 and 109).

2. Acquisition financing

27. A first-to-register priority rule means that a security right in the future assets of an enterprise (that is, assets that are acquired or come into existence after the security right is created), a notice of which is registered, will have priority over security rights in the same assets (that is, assets that fall within the description of the encumbered assets in the first registered notice), a notice of which is registered later. This is reasonable, as a general rule, since the subsequent secured creditor could and should have protected itself by searching the registry before extending credit. However, secured transactions laws often recognize that there should be an exception to this priority rule where the subsequent secured creditor is financing the grantor's acquisition of tangible assets (for example, consumer goods, equipment or inventory) or intellectual property. As these new assets would not have formed part of the grantor's asset base but for the new financing, it is considered fair that the acquisition financier (the later-registered secured creditor) should have priority with respect to the value of those assets over of the earlier-registered creditor. Giving priority to acquisition security rights (including retention-of-title rights and financial lease rights, in the context of the unitary approach to acquisition financing; see the term "acquisition security right" in the introduction to the *Guide*, sect. B) also benefits the grantor by giving it access to diversified sources of secured credit to finance new acquisitions (see the *Guide*, chap. IX). To preserve its special priority status, the acquisition secured creditor is generally required to register a notice in a timely fashion following delivery of the asset to the grantor and may also be required to notify the earlier registered secured creditor where the assets constitute inventory in the hands of the grantor; acquisition security rights in

consumer goods, however, may be excepted from the requirement for registration. This is the approach recommended in the *Guide* (see recommendation 180). The same approach is also recommended by the *Guide* for systems that treat acquisition financing in the form retention-of-title rights and financial lease rights as distinct from security rights (see paras. 38 and 39 below).

3. Ordinary-course-of-business transactions

28. In many States, a buyer that acquires an encumbered asset without actual knowledge that it is subject to a security right ("a good faith buyer") takes the asset free of a security right. Under this approach, a potential buyer is not only under no obligation to search the registry to determine whether the asset in which it is interested is subject to a security right, but also has a positive incentive not to search. This level of protection is incompatible with the goal of a comprehensive registry system aimed at facilitating publicity of security rights and establishing clear and objective rules for resolving contests between competing claimants. Consequently, secured transactions regimes that have established a general security rights registry typically enable a secured creditor that has registered a notice of its security right to follow the asset into the hands of a buyer from the grantor regardless of whether the buyer has actual knowledge of the registered security right. This is the approach recommended in the *Guide* (see recommendation 79).

29. However, the secured creditor's general right to enforce its security right against an encumbered asset in the hands of a buyer is subject to an important qualification. Secured transactions laws almost invariably provide that a buyer that purchases a tangible asset in the ordinary course of the grantor's business acquires the asset free of any security right in it, whether a notice about it is registered or not. This is also the approach recommended in the *Guide* (see recommendation 81). The ordinary-course-of-business exception typically protects a buyer even when the buyer has actual knowledge of the existence of a security right that became effective against third parties by registration. It is only if the buyer additionally knows that the sale violates the rights of the secured creditor under the security agreement that the buyer's title will be subject to the security right.

30. This approach is consistent with the reasonable commercial expectations of both the grantor and the secured creditor. It is not realistic to expect buyers dealing with a commercial enterprise which routinely sells the type of asset in which the buyer is interested, for example, computer equipment, to check the registry before entering into the transaction. Moreover, a secured creditor that takes a security right in a grantor's inventory will normally have done so on the understanding that the grantor may dispose of the inventory free of the security right in the ordinary course of the grantor's business. After all, for the grantor to be able to generate the revenue necessary to pay back the secured loan, the law must assure its customers that they will acquire unencumbered title in any inventory sold to them.

4. Money, negotiable instruments and negotiable documents

31. Secured transactions laws typically extend similar protection to transferees and competing secured creditors to whom money is paid or in whose favour negotiable documents (such as a bill of lading) or negotiable instruments (such as a cheque) are negotiated. This is the approach recommended in the *Guide* (see recommendations 101, 102, 108 and 109). Here, the policy of preserving the free

negotiability of these types of asset in the market place is considered to outweigh the risk to the priority position of the registered secured creditor.

5. Bank accounts and securities

32. In the interest of facilitating transactions by large financial institutions in the securities lending, repurchase and derivatives markets, legal systems sometimes create exceptions to registration-based priority rules for security rights in bank accounts and in, at least, certain types of securities (although it should be noted that securities and payment rights arising under or from financial contracts and foreign exchange contracts are excluded from the scope of the *Guide*; see recommendation 4, subparas. (c)-(e)). In these systems, secured creditors typically have the option of taking "control" of the bank account or securities in lieu of registration; and secured creditors with "control" have priority even over earlier-registered security rights. This is the approach recommended in the *Guide* (with respect to bank accounts, see the term "control" in the introduction to the *Guide*, sect. B, and recommendation 103).

6. Assets subject to specialized registration

33. Other exceptions to the first-to-register priority rule may be based on a State's decision to retain existing well-functioning alternatives to registration in the general security rights registry. Some States, for example, have adopted a system for noting security rights on the title certificates for motor vehicles. A State may give priority to a security right noted on a title certificate as against a security right registered in the general security rights registry and may also require a notation on the title certificate for the secured creditor to prevail against a subsequent transferee. This is the approach recommended in the *Guide* (see recommendations 77 and 78).

34. In addition, some States already have in place specialized registries for recording rights, including security rights, in specific types of movable asset, notably, ships, aircraft and intellectual property. To the extent that these registries may serve broader goals than simply publicizing security rights in the relevant assets (for example, also recording ownership or transfers of ownership), a State may decide to give priority to security rights registered in a specialized registry as against a security right registered in the general registry; a State may also require registration in the specialized registry for the secured creditor to prevail against a subsequent transferee. This approach is recommended in the *Guide* (see recommendations 77 and 78).

35. Finally, States that are parties to international treaties, such as the Convention on International Interests in Mobile Equipment and its Protocols require registration in the international registry for security and other rights in the types of asset to which these treaties apply (for example, aircraft frames and engines, railway rolling stock and space assets).

7. Other exceptions

36. The extent to which other exceptions are recognized depends on the particular social and economic context of each State. Some States, for example, protect buyers of relatively low-value consumer assets, whether or not purchased in the ordinary

course of the seller's business. In those States, the theory is that it is unrealistic to expect them to undertake a registry search in advance of the transaction.

G. Transactional scope of the registry

1. General approach: substance over form

37. Subject to the exceptions already noted, an efficient and effective registration-based secured transactions regime should be comprehensive in scope, covering all transactions that in substance operate as security regardless of the form of the transaction, the type of encumbered asset, the nature of the secured obligation or the status of the parties. This is the approach recommended in the *Guide* (see recommendation 2). So, for example, if a debtor transfers title to an asset to a creditor under a "sale", but retains possession on the understanding that title may be redeemed on payment of the outstanding obligation, the sale should, in principle, be regulated by the same registration and priority rules that apply to nominal security rights. This approach is necessary to avoid undermining the benefits of risk reduction and efficient priority ordering resulting from the establishment of a general security rights registry.

2. Title retention security devices

38. In some States transactions in which a creditor retains title to an asset for the purpose of securing payment of its acquisition price by the debtor are treated in the same way as secured transactions for the limited purposes of secured transactions law and title-retention rights or financial lease rights are subsumed under the concept of "security right" and brought within the scope of the general security rights registry. This is the unitary approach to acquisition financing recommended in the *Guide* (recommendation 178). In other States, retention-of-title devices are treated as conceptually distinct from security rights granted in assets already owned by the grantor. However, even in these States, it is generally recognized that title retention security devices raise the same publicity concerns as traditional security rights. In the absence of a registration requirement, a third party would have no means of objectively verifying whether assets in a person's possession may in fact be subject to the ownership rights of a seller or lessor. Consequently, these States often also bring retention-of-title devices within the scope of the general security rights registry, while retaining the different terminology. This is the non-unitary approach recommended in the *Guide* (see recommendations 187). Both the unitary and the non-unitary approach to acquisition financing recommended in the *Guide* follow the "substance over form" approach.

39. The seller's or lessor's acquisition security right ensures that its rights in the asset are protected from the reach of a previously registered security right granted by the buyer or lessee in future assets of the same kind. In systems that adopt the unitary approach to acquisition financing recommended in the *Guide*, the seller or lessor is entitled to repossess the asset on the default of the buyer or lessee and satisfy the secured obligation (the purchase price) from the proceeds of the disposition of the asset in preference to any non-acquisition secured or other creditor. In systems that adopt the non-unitary approach of the *Guide*, the seller or lessor may repossess the asset on the default of the buyer or lessee free of any claim

by the earlier registered secured creditor. This result is appropriate for the same reasons that justify an exception to the first-to-register priority rule for the holders of acquisition security rights (see recommendation 180 and para. 25. above). First, the grantor acquired the asset as a result of the seller or lessor's extension of credit, not the credit extended by the earlier registered secured creditor. Second, giving priority to an earlier registered security right would discourage access to sales and lease financing. Consequently, a secured transactions regime generally protects the seller or lessor against competing claimants provided registration of a notice has been made in a timely fashion (see recommendations 192-194).

3. Outright assignments of receivables

40. An outright assignment of a receivable creates the same problem of information inadequacy for third parties as a non-possessory security right. A potential secured creditor or assignee has no efficient means of verifying whether the receivables owed to a business have already been assigned. While inquiries could be made of the debtors of the receivables, this is not practically feasible where the transaction covers present and future receivables generally. To address this concern, secured transactions laws often extend the registration requirements applicable to non-possessory security rights to outright assignments of receivables, with priority among successive assignees or secured creditors of the same receivables determined by the order of registration. Other outright transfers, such as ordinary sales, are not made subject to registration, since, unlike outright assignments of receivables, they do not perform a financing function.

41. Bringing outright assignments of receivables within the scope of the registry does not mean that these transactions are re-characterized as secured transactions. It merely ensures that an outright assignee of receivables is subject to the same rules relating to creation, third-party effectiveness, and priority (but generally not enforcement) as the holder of a security right in receivables. It also means that the outright assignee has the same rights and obligations vis-à-vis the debtor of the receivable as a secured creditor. This is the approach recommended in the *Guide* (see chap. I, paras. 25-31, and recommendations 3 and 167).

4. Other types of transaction

(a) True leases and consignment sales

42. True long-term leases and consignment sales of movable assets do not operate to secure the acquisition price of assets. However, they create analogous publicity problems for third parties since they necessarily involve a separation of a property right (the ownership of the lessor or consignor) from actual possession (which is with the lessee or consignee). To address this concern, some States expand the scope of the registration and priority regime applicable to acquisition security rights and retention-of-title devices, to these types of transaction. This approach also allows the lessor or consignor to register so as to protect themselves against the risk that a court may find that a transaction that appeared to be a true lease or a true consignment was actually a secured transaction and thus ineffective if a notice with respect to it was not registered. The *Guide*, however, does not recommend this approach.

(b) Statutory rights

43. A registry of security rights in movable assets is designed primarily to accommodate the registration of a security right created by agreement of the parties. However, in some States, a right that may amount to a security right or give equivalent protection created by operation of law may also be registered. Such rights include, for example, rights of a State in the assets of a taxpayer for unpaid taxes (see the *Guide*, chap. V, paras. 90-109). In those States, the same registration and priority rules that apply to security rights apply to preferential rights created by operation of law.

44. However, the *Guide* does not recommend this approach. It treats statutory claims as preferential claims that should be limited both in type and amount (see recommendation 83). As a result, a creditor holding such a right does not need to register, the first-to-register priority rule does not apply and third parties should be aware of this risk and investigate accordingly.

H. Territorial scope of the registry

45. Registry users require clear guidance on where a notice of a security right must be registered in situations where the transaction involves parties and assets located in different States. Typically, this guidance is found in a State's conflict-of-laws rules for determining the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right. Under the approach adopted in modern conflict-of-laws regimes such as the one recommended in the *Guide*, the applicable law depends on the nature of the assets. For security rights in tangible assets, the law of the State in which the encumbered asset is located applies (see recommendation 203). Where the encumbered assets are located in multiple States, the law of each such State applies. If these States have registries, multiple registrations will be necessary. For security rights in intangible assets, as well as mobile goods of a kind that are commonly used in multiple States, the law of the State in which the grantor is located applies (see recommendations 204 and 208).

46. However, different conflict-of-laws rules apply to security rights in certain types of asset, such as receivables arising from a transaction relating to immovable property, rights to payment of funds credited to bank accounts, rights to receive the proceeds under an independent undertaking, intellectual property rights and proceeds (see recommendations 209-215 and 248). For example, where the encumbered asset is intellectual property the applicable law is primarily the law of the State in which the intellectual property is protected, although a security right may also be created and made effective against the grantor's insolvency representative and judgement creditors, and may be enforced only, under the law of the State in which the grantor is located (see *Supplement on Security Rights in Intellectual Property*, recommendation 248).

I. Effect of actual or imputed knowledge of an unregistered security right on third-party effectiveness and priority

47. In States that lack a general security rights registry, the law often provides that a third party that acquires an encumbered asset without actual or imputed

knowledge that the asset is subject to a security right takes the asset free of that security right. In States that have implemented a general security rights registry of the kind contemplated by the *Guide* actual or imputed knowledge of the existence of a security right is not a substitute for registration and the acquisition of an encumbered asset with knowledge of the existence of an unregistered security right does not constitute bad faith. This approach enables third parties to place full confidence in the registry system to determine whether or not they are bound by any security rights the grantor may have given in its assets. It is not unfair to secured creditors since they could have protected themselves by timely registration.

J. Registration and insolvency

48. Modern secured transactions and insolvency laws generally make registration a pre-condition to the effectiveness of a security right against the grantor's unsecured judgement creditors and insolvency representative. This is the approach recommended in the *Guide* (see recommendations 238 and 239) in line with the UNCITRAL Legislative Guide on Insolvency Law. Failure to register a notice or otherwise make a security right effective against third parties, at all or in time, means that the secured creditor is effectively demoted to the status of an unsecured creditor as against competing claimants, including the grantor's judgement creditors and insolvency representative.

49. This rule:

(a) Encourages prompt registration by secured creditors;

(b) Enables the grantor's insolvency representative to determine efficiently which of the grantor's assets are encumbered;

(c) Enables judgement creditors to determine at any given time the extent to which the grantor's assets are encumbered, thereby enabling them to determine whether it is worthwhile to commence judgement enforcement proceedings; and

(d) Enables potential creditors to determine the possible extent of secured indebtedness of their potential debtors at any given time, knowledge that may contribute to their overall assessment of creditworthiness of a potential debtor.

50. Timely registration does not, however, protect a secured creditor from challenges on the basis of general insolvency law policies, such as rules avoiding preferential or fraudulent transfers and rules giving priority to certain protected classes of creditors (see the *Guide*, chap. XII, and recommendation 239; see also recommendations 88 and 188 of the UNCITRAL Legislative Guide on Insolvency Law).

51. In addition, modern secured transactions and insolvency laws generally allow the secured creditor to take an action to continue, preserve or maintain the effectiveness of the security right against third parties even after the commencement of insolvency proceedings (see recommendation 238). Accordingly, the secured creditor should be able to extend the effectiveness of the registration that would otherwise expire during the insolvency proceedings by registering the relevant notice of amendment.

52. Moreover, modern insolvency laws generally authorize the insolvent grantor to create a security right to obtain post-commencement finance (see recommendation 65 of the UNCITRAL Legislative Guide on Insolvency Law). Such post-commencement finance does not have priority over existing secured creditor(s) unless agreed to by the existing secured creditor(s) or authorized by the court with the appropriate protections for the secured creditor. When post-commencement finance is provided, the notice of registration must identify the grantor appropriately depending on the type of insolvent person (see A/CN.9/WG.VI/WP.46/Add.1, para. 23).

K. Registration and creation of a security right

53. Under the secured transactions regime recommended in the *Guide*, registration is not an element of the creation of a security right (see recommendation 33). Rather the security right takes effect and becomes enforceable between the grantor and the secured creditor as soon as a security agreement that meets minimal formalities such as writing and evidence of the grantor's consent to encumber its assets is concluded (see recommendations 13-15). Registration is purely a precondition to the third-party effectiveness of the security right. In addition, as explained in detail below, what is registered is not the security agreement itself but rather only basic information provided in a notice with respect to a potential security right (see recommendation 32 and paras. 65-69 below). The registration does not constitute evidence that the security right to which it refers actually exists. It is the off-record security agreement that evidences the security right. Registration merely alerts third-party searchers of the possible existence of a security right in the described assets.

L. Registration and enforcement

54. Some legal regimes require secured creditors to register a notice of the initiation of enforcement action. In those regimes, usually the registry is required to notify earlier registered secured creditors that hold a security right in the same asset of the pending enforcement action. the *Guide* does not recommend imposing an obligation on the secured creditor to register notice of pending enforcement action The *Guide* rather recommends a different approach in the sense that the enforcing secured creditor is required to search the registry and to notify interested third parties (including competing claimants) of the particular enforcement remedy that it seeks to exercise (see recommendation 151).

M. Consequences of the failure to register

55. The *Guide* does not require that a secured creditor register a notice of its security right and thus does not recommend the imposition of monetary penalties or other administrative or other sanctions on secured creditors for failing to do so. The only adverse consequence of a failure of a secured creditor to register a notice of its security right is that the security right will not be effective against certain third parties as described in the *Guide*.

N. Coordination of the security rights registry and specialized movable property registries

56. Where specialized registries exist and permit the registration of security rights in movable assets with third-party effects (as is the case with the international registries under the Convention on International Interests in Mobile Equipment and its Protocols), modern secured transactions and registry regimes deal with matters related to the coordination of registrations in the two types of registry. The *Guide* and the *Supplement on Security Rights in Intellectual Property* discuss coordination of registries in some detail (see the *Guide*, chap. III, paras. 75-82, chap. IV, para. 117; see also the Supplement, paras. 135-140, and the Supplement, paras. 135-140).

57. For example, the *Guide* provides that a security right in an asset subject to specialized registration may be made effective against third parties by registration in the general security rights registry or in the specialized registry and addresses the issue of coordination between the two types of registry through appropriate priority rules, giving priority to a security right, a notice of which is registered in the relevant specialized registry, over a security right in the same asset, a notice of which is registered in the general security rights registry (see recommendations 43 and 77, subpara. (a)).

58. The *Guide* also discusses other ways of coordination of registries, including the automatic forwarding of information registered in one registry to another registry and the implementation of common gateways to the various registries to the relevant registries. This approach raises complexities with respect to the design of the general security rights registry where the specialized registry organizes registrations by reference to the asset as opposed to the grantor based indexing system used in the general security rights registry (see the *Guide*, chap. III, paras. 77-81; see also paras. 70-72 below).

O. Coordination of the security rights registry and immovable property registries

59. Immovable property registries exist in most, if not in all, States. In most States, the general security rights registry is separate from the immovable property registry owing to differences in the requirements for the description of the encumbered asset and indexing structures (see further, paras. 70-72 below) as well as to the legal effects of registration as against third parties.

60. However, a State implementing a general security rights registry will need to provide guidance on where notices relating to security rights in attachments to immovable property should be registered. Modern secured transactions regimes along the lines recommended in the *Guide* provide that such registrations may be made either in the general security rights registry or in the immovable property registry (see recommendation 43). The choice between the two types of registration has priority consequences. The *Guide* recommends that an encumbrance registered in the immovable property registry has priority over a security right a notice with respect to which registered only in the security rights registry (see recommendation 87). The *Guide* also recommends that the security right will be

ineffective against a buyer or other third party that acquires a right in the immovable property unless a notice with respect to the security right is registered in the immovable property registry in advance of the sale (see recommendation 88).

61. It should also be noted that the asset description requirements as to notices relating to security rights in attachments to immovable property may differ depending on whether the notice is to be registered in the general security rights registry or in the immovable property registry. The *Guide* requires that an attachment to immovable property be described in a manner that reasonably allows its identification (see recommendation 57, subpara. (b)). A description of the tangible asset that is or will be attached without a description of the immovable property is sufficient for the purposes of indexing such notice in the general security rights registry. In contrast, indexing of such notice in the immovable property registry will generally require that the immovable property to which the tangible asset is or will be attached be described sufficiently under the law of immovable property. Such description must be sufficient to allow the indexing of the notice in the immovable property registry.

III. Key characteristics of an effective security rights registry

A. Introduction

62. Most States have established registries for recording title and encumbrances on title with respect to transactions involving immovable property as well as certain types of high-value movable asset, such as ships and aircraft. It is essential to the successful implementation of an effective security rights registry that its very different characteristics be well understood by those responsible for its design and operation, as well as by its potential clientele. Accordingly, this chapter explains the key characteristics of an efficient and effective security rights registry (the detailed legal rules and design considerations necessary to implement these key characteristics are addressed in subsequent chapters).

B. Determining title to encumbered assets

63. A title registry, such as the typical land, aircraft or ship registry, operates to disclose both the current owner of a particular asset and any encumbrances on the owner's title. However, it would not be administratively practical or cost effective to attempt to establish a reliable ownership record for the great bulk of tangible and intangible movable assets that are commonly made the subject of security rights. Consequently, a general security rights registry for movable assets of the kind contemplated by the *Guide* does not record the existence or transfer of title to the encumbered asset described in the registration or guarantee that the person named as grantor in the registration is the true owner. It is purely and simply a record of potentially existing security rights on whatever property right the grantor has or may acquire in the assets described in the registration as a result of off-record transactions or events.

64. As explained earlier, the *Guide* recommends that retention of title under sale or financial lease agreement be made subject to the general security rights

registration regime even in States that do not treat this type of transaction as giving rise a security right (see paras. 38 and 39 above). Similarly, the *Guide* recommends that the title acquired by an outright assignee of a receivable be subject to the general security rights registration regime (see paras. 40 and 41 above). Also as noted earlier (see para. 42 above), while this is recommended by the *Guide*, some States extend the general security rights registration regime to true long-term leases and commercial consignments. In addition, some States that have not extended the scope of their security rights regimes to cover true leases and commercial consignments, precautionary registrations may be made with respect to such transactions as a protective measure against the possibility that a court may find that what appeared to be a true lease or a commercial consignment was actually a secured transaction (see para. 42 above). In these types of transaction, the registration refers not to a security right but to the ownership right of the assignee, retention-of-title seller, lessor or consignor. However, registration even in these cases does not establish or evidence ownership; it merely provides notice that the assignee, retention-of-title seller, lessor or consignor may hold title to the described assets. Whether these parties hold title or not depends on off-record evidence of the transactions or events under which title is claimed.

C. Notice versus document registration

65. Registry systems for recording title and encumbrances on title to specific parcels of land or specific movable assets, such as ships, typically require registrants to file or tender for scrutiny the underlying documentation. This is because registration generally is considered to constitute evidence or at least presumptive evidence of title and any property rights affecting title.

66. In some States, security rights registries still require submission of the underlying security documentation. However, in line with modern secured transactions regimes, the *Guide* recommends notice registration (see recommendations 54, subpara. (b), and 57). A notice-registration system does not require the actual security documentation to be registered or even tendered for scrutiny by registry staff. All that need be registered is the basic information necessary to alert a searcher that a security right may exist in the assets described in the notice. It follows that registration does not mean that the security right to which the notice refers necessarily exists; only that one may exist at the time of registration or later.

67. The *Guide* recommends notice registration rather than document registration because notice registration requires significantly less information to be transmitted to the registry and thus:

(a) Reduces transaction costs for both registrants (as they would not need to register all the security documentation) and third-party searchers (they would not need to peruse voluminous documentation that might be on record or hire special service providers to produce an assessment of the grantor's assets as reflected on public record);

(b) Reduces the administrative and archival burden on registry system operators;

(c) Reduces the risk of registration error (since the less information that must be submitted, the lower the risk of error); and

(d) Enhances privacy and confidentiality for secured creditors and grantors.

68. As already mentioned, in a notice registration system as the one recommended in the *Guide*, registration does not create a security right; it simply makes a security right effective against third parties if it exists at the time of registration or, in the case of advance registration, comes into existence later (see recommendations 32, 33 and 67). In addition, while a registration is not effective unless authorized by the grantor in writing (including an electronic communication; see recommendations 111 and 12), an authorization contained in the security agreement is sufficient and may be given even after registration (see recommendations 55, subpara. (d), and 71, and A/CN.9/WG.VI/WP.46/Add.1, chap. IV, sect. B). To protect a grantor from an unauthorized registration that does not give any rights to the unauthorized secured creditor but may prevent the grantor from utilizing its assets to obtain credit, the grantor is entitled to seek cancellation or amendment of a registration through a summary administrative or judicial procedure (see recommendations 55, subpara. (c), and 72, subpara. (b), and A/CN.9/WG.VI/WP.46/Add.1, chap. IV, sect. H). Any additional sanctions aimed at protecting grantors against unauthorized registrations depend on a determination made by each State as to the extent of the risk of unauthorized and fraudulent registrations relative to the cost of administering prescriptions of this nature (see the *Guide*, chap. IV, para. 20).

69. In a notice registration system like the one recommended in the *Guide*, the registry merely serves as a repository of information received by it, and the legal effect of that information is determined by the substantive rules of the secured transactions regime. Accordingly, no information submitted by registrants is subject to verification or substantive change by those administering the registry. Similarly, as discussed below, any changes in information that a registrant wishes to add to the record are submitted separately and do not have the effect of deleting information that was earlier registered. In other words, an amendment is not effected by deleting the currently registered information and replacing it with the new information. Instead, an amendment is added to the initial registration information so that the searcher is able to find and examine both the originally registered information as well as the information subsequently registered. Neither registrants nor registrars are able to replace any information from the registry record, and registry systems should be designed accordingly. Unlike standard registries, in a general security rights registry, once a registration is completed, there is no means to edit a registration and all changes must be in the form of subsequent amendment notice (see recommendation 72).

D. Grantor versus asset indexing

70. Immovable property generally has a sufficiently unique geographical identifier to enable registrations to be indexed and searched by reference to the asset. By contrast, most types of movable asset lack a sufficiently specific or unique objective identifier to support asset-based indexing. Moreover, a modern secured transactions law must accommodate the creation of an effective security right in pools of present

and future assets such as the grantor's equipment, inventory and receivables; requiring an item-by-item specific description for these types of asset would make the registration process cumbersome and prone to errors in descriptions.

71. For these reasons, information contained in notices registered in a security rights registry of the kind contemplated in the *Guide* is indexed by reference to the identifier of the grantor (the grantor's name or other identifier such as a State-issued identification number) as opposed to the asset (see the *Guide*, chap. IV, paras. 31-33 and 70, and chap. IV, sect. K). Grantor indexing greatly simplifies the process of registration. Secured creditors can register a security right in a grantor's present and future movable assets generally, or in generic categories, through a single one-time registration. This is the approach recommended in the *Guide* (see recommendation 57, subpara. (a))

72. Some security rights registration regimes provide for supplementary asset-based registration and indexing in respect of specific types of high-value asset for which reliable alpha-numerical identifiers are available and for which there is a significant re-sale market (for example, motor vehicles, trailers, mobile homes, aircraft frames and engines, railway rolling stock, boats and boat motors). Although the *Guide* does not recommend this approach, it discusses it and its rationale (see chap. IV, paras. 34-36). This approach is further discussed in chapter IV below.