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Draft Guide to Enactment of the draft Model Law on Secured Transactions

Note by the Secretariat

Addendum

Contents

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Chapter V. Priority of a security right

A. General rules

Article 28. Competing security rights

1. Article 28 is based on recommendation 76 of the Secured Transactions Guide (see chap. V, paras. 45-54). It addresses two related topics. First, it addresses priority between competing security rights in the same encumbered asset in cases in which the security rights were granted by the same grantor. Second, it addresses priority between competing security rights in the same encumbered asset in cases in which the security rights were granted by different grantors. The first situation is more common. The second situation can occur, for example, if Grantor A creates a security right in its equipment in favour of Secured Creditor ("SC") 1 and then transfers the equipment to Transferee B who creates a security right in it in favour of SC 2.

2. As a general matter, priority between competing security rights is determined by the order in which the security rights became effective against third parties. This rule is reflected in paragraphs 1 and 2. Most often, third-party effectiveness of a security right is achieved by registration of a notice in the security rights registry (see art. 18). Because registration of a notice may precede creation of the security right (see art. 5 of the registry-related provisions*), a special rule for that circumstance is provided in paragraph 3. Paragraphs 1 and 2 also apply, however, in the wide variety of situations in which a method of third-party effectiveness other than registration of a notice is utilized, subject to certain exceptions (see paras. 29-40 below).

3. Under paragraph 3, a special rule is provided for cases in which one or both of the competing security rights was made effective against third parties by registration of a notice that preceded creation of the security right. Under the provisions of chapter II, such a security right is not effective against third parties until it has been created, but under paragraph 3 the time of the pre-registration is relevant for determining priority. In particular, paragraph 3 provides that the priority of that security right as against other security rights is determined by the time of registration rather than the time of third-party effectiveness. This means that in applying the rule in paragraph 1 or paragraph 2 to a priority determination between security rights one or both of which was the subject of a pre-registered notice, the time of such pre-registration, rather than the later date of third-party effectiveness (i.e., the time at which the security right was created), should be used.

4. To illustrate this rule, assume that: (a) on Day 1, Grantor authorized SC 1 to register a notice listing Grantor as the grantor and describing the encumbered assets as all present and future equipment of Grantor and SC 1 registered the notice; (b) on Day 2, Grantor borrowed money from SC 2 and granted SC 2 a security right in all of Grantor's present and future equipment and SC 2 registered a notice with respect to this security right; and (c) on Day 3, Grantor borrowed money from SC 1 and granted SC 1 a security right in all of Grantor's present and future equipment. In this case, the security right of SC 2 became effective against third parties before the

* Reference is to this article as it is contained in document A/CN.9/WG.VI/WP.65/Add.1.

security right of SC 1 (because SC 1's security right did not become effective against third parties until it was created). Yet, as a result of the rule in paragraph 3, in determining the priority between the security rights of SC 1 and SC 2 under paragraph 1, the time of registration of SC 1's notice, rather than the later date on which SC 1's security right became effective against third parties, is used. Thus, SC 1 has priority over SC 2 because SC 1's registration of the notice (on Day 1) occurred before the security right of SC 2 became effective against third parties.

5. When combined with the rules in paragraphs 1 and 2, paragraph 3 results in the following priorities: (a) as between security rights that were made effective against third parties by registration of a notice, priority is determined by the order of registration, regardless of the order of creation of the security rights; and (b) as between a security right that was made effective against third parties by registration and a security right that was made effective against third parties otherwise than by registration, priority is determined by the order of registration or third-party effectiveness, whichever occurs first for each of the parties.

6. This rule is beneficial for two reasons. First, as a result of this rule, the priority date for security rights that are made effective against third parties by the registration of a notice will always be determined by the time of registration. The time of registration is maintained by the Registry and is, therefore, easy to demonstrate and easy to search. By way of contrast, the creation of a security right is a private event between the grantor and the secured creditor; the time of creation is not maintained by the Registry and is not publicly available and may be difficult to establish.

7. Second, the results that follow from the application of the rule in this article are consistent with the behaviour of prudent secured creditors. For example, assume that SC 2 is considering extending credit to Grantor, secured by a security right in an item of Grantor's equipment. If SC 2 searches the records of the Registry and discovers that a notice has been registered listing Grantor as the grantor and SC 1 as the secured creditor and indicating that the encumbered asset is the same item of equipment, SC 2 will not know whether SC 1 has a security right or, rather, has registered a notice before creation of the security right. In such a situation, SC 2 would likely make the conservative assumption that the registered notice reflects an existing security right and, accordingly, if SC 2 decides to go forward with the transaction, it will be with the understanding that its rights are subordinate to that of SC 1. The rule in this article is consistent with the behaviour of SC 2.

Article 29. Competing security rights in the case of a change in the method of third-party effectiveness

8. Article 29 addresses situations in which there has been a change in the method of third-party effectiveness. This may happen, for example where a secured creditor in possession of the encumbered asset returns possession of it to the grantor after registering a notice with respect to it in the security rights registry. In such a case, the priority of the security right is determined by the time at which the security right was first effective against third parties so long as there was no time thereafter during which the security right was not effective against third parties.

Article 30. Competing security rights in proceeds

9. Article 30, which is based on recommendation 100 of the Secured Transactions Guide (see chap. V, paras. 144-150), is important because in many cases one or both of the competing security rights in the encumbered asset will be a security right that the secured creditor has in that asset because that asset is proceeds of a different encumbered asset that, for example, the grantor has sold. This is quite common when the original encumbered asset is inventory or a receivable inasmuch as the grantor frequently sells the inventory or collects the receivable before satisfaction of the obligation secured by the encumbered asset. In such a case, the security right continues in the proceeds as provided in article 10 and the security right in the proceeds is effective against third parties if the conditions in article 19 are satisfied. This article determines the priority of that security right in proceeds as against another secured creditor with a security right in the same encumbered asset, whether as original encumbered asset or as proceeds. Under this article, the priority of the security right in the proceeds is the same as the priority of the security right in the original encumbered asset.

10. Thus, for example, assume that: (a) on Day 1, Grantor grants SC 1 a security right in all of Grantor's present and future inventory and SC 1 registers a notice with respect to that security right; (b) on Day 2, Grantor grants SC 2 a security right in all of Grantor's present and future receivables and SC 2 registers a notice with respect to that security right; and (c) on Day 3, Grantor sells the inventory on credit, generating a receivable. SC 2 has a security right in that receivable because of its security right in present and future receivables, and SC 1 has a security right in that receivable because it is proceeds of the inventory in which SC 1 had a security right. SC 1's security right in the receivable has priority over SC 2's security right because SC 1's priority in the receivable as proceeds is determined utilizing the date of third-party effectiveness or registration of notice with respect to the security right in the inventory, whichever came first (see art. 28). Thus SC 1's priority in the receivable dates from Day 1, while SC 2's priority in the receivable dates from Day 2 (for security rights in proceeds of acquisition security rights, however, see art. 39).

Article 31. Competing security rights in tangible assets commingled in a mass or product

11. Article 31 addresses two priority issues resulting from situations in which one or both of the competing security rights is a security right that continued to a mass or product because the original encumbered asset was commingled in that mass or product (see Secured Transactions Guide, chap. V, paras. 117-124 and recs. 90 and 91). First, in paragraph 1, it addresses situations in which the competing security rights were in the same encumbered asset and that asset became part of a mass or product. In that case, the order of priority of the two security rights in the mass or product is the same as the order of priority of the security rights in the original encumbered asset.

12. Second, in paragraphs 2 and 3, it addresses situations in which the competing security rights were originally in different encumbered assets and both of those encumbered assets became part of the same mass or product. In such as case, if the value of the two security rights in the mass or product, as determined in article 11, is insufficient to satisfy the two secured obligations, the secured parties share the

aggregate maximum value of their security rights in same proportion as the ratio of the value of the two security rights in the mass or product.

13. [Illustrations will be added after a determination is made whether to retain only one of options A and B in article 11 or both options.]

Article 32. Security rights competing with rights of buyers or other transferees, lessees or licensees of an encumbered asset

14. Article 32 is based on recommendations 79-82 of the Secured Transactions Guide (see chap. V, paras. 60-89). It addresses situations in which the encumbered asset is sold or otherwise transferred, leased or licensed, and determines the rights of the buyer or other transferee, lessee or licensee vis-à-vis the security right.

15. The general rule, which is stated in paragraph 1 and is subject to important exceptions stated in paragraphs 2-6, is that a security right in an encumbered asset that is effective against third parties continues to encumber the asset notwithstanding the sale or other transfer, lease or licence of the encumbered asset.

16. The article provides two types of exceptions to the general principle stated in paragraph 1. Paragraphs 2 and 3 provide exceptions based on the actions of the secured creditor, while paragraphs 4-6 provide exceptions based on the nature of the sale or other transfer, lease or licence and the knowledge of the buyer or other transferee, lessee or licensee.

17. Paragraph 2 provides that, if the secured creditor authorizes the sale or other transfer of the asset free of the security right, the buyer or other transferee takes free of that security right. The rule in this paragraph fulfils the intention of the parties inasmuch as the secured creditor has, by its authorization, evidenced intent for the general rule in paragraph 1 not to apply. Such an authorization may occur, for example, when a sale transfer of the encumbered asset free of the security right will generate sufficient proceeds that the grantor can use to satisfy the secured obligation, but a sale subject to the security right would not do so. Paragraph 3 brings about the same result in the case of a lease or licence of the encumbered asset. It is stated differently than the rule in paragraph 2 because some, but not all, States do not characterize the rights of a lessee or licensee as property rights.

18. Paragraphs 4-6 protect a buyer, lessee, or licensee of an encumbered asset in an ordinary course of business transaction from being subject to a security right in that asset that encumbered it while in the hands of the seller, lessor, or licensor. Under paragraph 4, a buyer of a tangible encumbered asset acquires its rights free of the security right if two conditions are satisfied. First, the sale must have been in the ordinary course of the seller's business. Thus, for example, the sale of some of a seller's inventory in accordance with the typical business practices of the seller would satisfy this condition, but an atypical sale by that seller of a used item of the seller's equipment would not satisfy this condition. The second condition is that buyer must have acquired the encumbered asset without knowledge (as of the time of the conclusion of the agreement with the seller pursuant to which buyer acquired the asset) that the sale violated the rights of the secured creditor under the security agreement. "Knowledge" is defined in article 2, subparagraph (r), as actual knowledge. It is important to note that knowledge of the existence of the security right, as opposed to knowledge that the sale violated the secured creditor's rights, is insufficient to disqualify the buyer from the benefits of paragraph 4. If, for example,

a buyer knows that the seller has encumbered its inventory, but does not know whether the secured creditor has authorized sales of that inventory free of the security right, the buyer has knowledge of the security right but does not have knowledge of whether the sale violated the rights of the secured creditor.

19. Paragraphs 5 and 6 bring about similar results to those in paragraph 4 in the case of leases of tangible encumbered assets and non-exclusive licences of intellectual property. As with paragraph 3, the formulation of paragraphs 5 and 6 differs from the formulation of paragraph 4, because some, but not all, States do not characterize the rights of a lessee or licensee as property rights.

20. Paragraphs 7 and 8 state what is often referred to as a "shelter principle" — once a buyer, lessee, or licensee obtains rights in the encumbered asset free of (or unaffected by) a security right, those that acquire their rights in the encumbered assets from or through the buyer, lessee, or licensee are similarly free of (or unaffected by) the security right.

Rights of buyers or other transferees, lessees or licensees of an encumbered asset in the case of specialized registration

21. States that provide a specialized registry or title certificate system for achieving third-party effectiveness of a security right in particular types of asset may wish to consider whether, in order to enable competing claimants that utilize the specialized registry or title certificate system to determine their rights solely by a search of the specialized registry system or examination of the title certificate, rights of such parties should be superior to the rights of a secured creditor that achieved third-party effectiveness by other means (see Secured Transactions Guide, chap. V, paras. 56 and 57, and rec. 77; for the coordination with specialized movable property registries, see Registry Guide, para. 64-70).

Article 33. Impact of the grantor's insolvency on the priority of a security right

22. Under article 33, nothing in the secured transactions law changes determinations of third-party effectiveness or priority merely because insolvency proceedings have been commenced. Thus, unless the applicable insolvency law provides to the contrary, a security right that is effective against third parties under the Model Law at the time of the commencement of insolvency proceedings remains effective against third parties and retains the priority it had before the commencement of the insolvency proceedings.

Article 34. Security rights competing with preferential claims

23. Article 34 is based on recommendations 83, 85 and 86 of the Secured Transactions Guide (see chap. V, paras. 90-93 and 103-109). Its purpose is to implement the policy of these recommendations and give an enacting State an opportunity to: (a) list in a clear and specific way any statutory claims that may have priority over security rights; and (b) indicate a limitation on their amount. Examples of claims that may be listed in this article include claims of service providers and unpaid sellers or suppliers of goods but only to the extent that they have retained possession of the goods (see A/CN.9/830, para. 89). It should be noted that secured creditors typically obtain representations from grantors about preferential claims and otherwise address the possible existence of such claims.

24. This article applies outside insolvency. As the Model Law does not deal with insolvency matters, it does not include a similar rule for preferential claims in the case of the grantor's insolvency along the lines of recommendation 239 of the Secured Transactions Guide. In most States that require registration of a notice with respect to preferential claims, the priority of preferential claims is determined in the same way as the priority of security rights, that is, in other words, the general first-to-register priority rule applies. It should also be noted that, in the case of enforcement, if a preferential creditor does not take over the enforcement process (see art. 70), its claim will have to be paid ahead of the claims of secured creditors.

Article 35. Security rights competing with rights of judgement creditors

25. Article 35 is based on recommendation 84 of the Secured Transactions Guide (see chap. V, paras. 94-102). It determines the priority as between a security right in an encumbered asset and the rights of a judgement creditor that has acquired rights in the encumbered asset by taking whatever steps are necessary under applicable law. The enacting State should complete paragraph 1 by inserting the relevant step or steps necessary for a judgement creditor to acquire rights in the encumbered asset. These steps may include actions such as registration of a notice in the security rights registry, seizure of assets or service of a garnishment order.

26. Paragraph 1 gives priority to the judgement creditor if the steps necessary for it to acquire rights in the encumbered asset occur before the security right becomes effective against third parties.

27. Paragraph 2 provides that, in cases in which the judgement creditor does not acquire its rights in the encumbered asset before the security right becomes effective against third parties, the security right has priority. However, paragraph 2 limits the extent of that priority by providing that the priority of the security right does not extend to credit extended by the secured creditor more than a short period of time after the judgement creditor notifies the secured creditor that it has taken the steps necessary to acquire its right, or to credit extended thereafter pursuant to an irrevocable commitment made before that notification. Paragraph 2 protects secured creditors against the possibility of inadvertently extending credit without realizing that their security rights are subordinate to the rights of a judgement creditor.

Article 36. Non-acquisition security rights competing with acquisition security rights

28. Article 36 is based on recommendations 180 of the Secured Transactions Guide (see chap. IX, paras. 131, 136, 137, 143 and 146) and recommendation 247 of the Intellectual Property Supplement (see paras. 259-263). Two alternative options are provided for the enacting State. Both options provide that, under certain circumstances, an acquisition security right has priority over a competing non-acquisition security right in the same encumbered asset even if, under the general priority rule in article 28, paragraph 1, the non-acquisition security right would have priority. When those circumstances are present, it is often said that the acquisition security right has "super-priority" over the competing non-acquisition security right.

29. “Super-priority” for acquisition security rights is a feature of the law of most States, whether phrased in terms of a higher priority for security rights securing obligations incurred in acquiring the encumbered asset or, in many legal systems, as a necessary implication of title to the encumbered asset being retained by the seller. Article 36 continues this advantageous treatment of acquisition finance, providing a variety of “super-priority” rules depending on the nature of the asset that is subject to the acquisition security right.

30. Option A contains three “super-priority” rules. Which of the three rules is applicable in a particular case depends on the nature of the encumbered assets. If the encumbered assets are equipment, the rule in paragraph 1 applies. If the encumbered assets are either inventory or the intellectual property equivalent of inventory (that is, intellectual property or rights of a licensee under a licence of intellectual property held by the grantor for sale or licence in the ordinary course of the grantor’s business, the rule in paragraph 2 applies. If the encumbered assets are consumer goods or the intellectual property equivalent of consumer goods (that is, intellectual property or rights of a licensee under a licence of intellectual property used or intended to be used by the grantor primarily for personal, family or household purposes), the rule in paragraph 3 applies.

31. Under the “super-priority” rule in paragraph 1 of option A, an acquisition security right in equipment has priority over a competing non-acquisition security right created by the grantor, if either the acquisition secured creditor is in possession of the asset (unlikely inasmuch as most acquisition security rights are non-possessory) or a notice with respect to the acquisition security right is registered in the Registry within a short period of time to be specified by the enacting State after the grantor obtains possession of the asset. Thus, so long as the acquisition secured creditor registers a notice with respect to the acquisition security right within the specified period, that security right will have priority over a competing non-acquisition security right that was made effective against third parties before the acquisition security right was made effective against third parties.

32. Under the super-priority rule in paragraph 2 of option A, additional requirements must be satisfied for an acquisition secured creditor with a security right in inventory or its intellectual property equivalent to have “super-priority” over a competing non-acquisition security right. In particular, two actions must occur before the grantor obtains possession of the encumbered asset in order for the acquisition security right to have “super-priority”. First, a notice with respect to the acquisition security right must be registered. Second, a notice stating that the acquisition secured creditor has or intends to acquire an acquisition security right and describing the asset sufficiently to enable the non-acquisition secured creditor to identify the asset that is the object of the acquisition security right must be received by the non-acquisition secured creditor (if the non-acquisition secured creditor has registered a notice in the Registry with respect to a security right created by the grantor in an asset of the same kind).

33. There are two reasons for this more stringent treatment. First, because inventory may “turn over” quickly and depreciate quickly, it would be economically inefficient for a secured creditor with a non-acquisition security right in present and future inventory to need to wait for the passage of the period of time stated in paragraph 1 before being certain that future inventory is not subject to an acquisition security right that will have super-priority of the rights. The requirement

that the actions required for super-priority in paragraph 2 take place before the grantor obtains possession of the encumbered asset addresses this concern. Second, inasmuch as new inventory can often be difficult to distinguish from old inventory, even a secured creditor with a security right in future inventory that monitors the assets of the grantor will not always be able to easily detect the presence of new inventory that has replaced similar older inventor. Thus, such a secured creditor may not be able to determine that some items of inventory are recently acquired and thus potentially subject to an acquisition security right. The notice requirement addresses this concern.

34. Paragraph 4 of option A contains two important rules about the notice required in subparagraph 2(b)(ii). First, such a notice may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction. Thus, for example, a seller that is planning to engage in a series of transactions with the same grantor, under which the seller will sell inventory to the grantor subject to an acquisition security right, may send a single notice to the competing non-acquisition secured creditor generally describing the set of transactions. Second, a notice suffices to bring about super-priority if the grantor acquires the assets subject to the acquisition security right if it is received not later than a time period to be specified by the enacting State (such as five years) after the grantor acquires the assets subject to the acquisition security right. As a result, a seller that provides a notice for a series of transactions in which acquisition security rights are created will not need to send another notice with respect to assets acquired not later than five years after the first notice is received.

35. Under the super-priority rule in subparagraph 3, an acquisition security right in consumer goods or their intellectual property equivalent automatically has priority over a non-acquisition security right in the same encumbered asset. No additional actions are required. [This paragraph to be adjusted when the Working Group reaches a decision about the bracketed language in paragraph 3.]

36. Option B contains only two “super-priority” rules. The first rule, found in paragraph 1, is identical to paragraph 1 of option A (which applies only to equipment) except that it also applies to inventory and the intellectual property equivalent of inventory. The second rule, found in paragraph 2, is identical to paragraph 3 of option A. Thus, the only difference between option A and option B is that, in the former, additional steps must be taken in order for an acquisition security right in inventory or in the intellectual property equivalent of inventory to have priority over a competing non-acquisition security right.

Article 37. Competing acquisition security rights

37. Article 37 is based on recommendation 182 of the Secured Transactions Guide (see chap. IX, paras. 173-178). It addresses the priority of competing security rights when both are acquisition security rights. Unlike article 36 (which gives priority to acquisition security rights that satisfy certain criteria as against non-acquisition security rights), this article addresses priority as between security rights both of which would otherwise be entitled to “super-priority”. The rule in article 37 reflects two policy decisions. First, an acquisition security right of a seller or lessor, or a licensor of intellectual property, should have priority over an acquisition security right of another person such as a lender. Second, in all other cases, priority between

acquisition security rights should be determined on the basis of rules applicable when neither are acquisition security rights.

Article 38. Acquisition security rights competing with the rights of judgement creditors

38. Article 38 is based on recommendation 183 of the Secured Transactions Guide (see chap. IX, paras. 145-148). Without the rule in this article, the period provided in article 36 would not be useful. The reason for this is that a secured creditor taking an acquisition security right typically would not want to have a period in which it would be vulnerable to the rights of a judgement creditor. In such a case, a secured creditor would likely register a notice before, or as soon as possible after, the security right was created. Accordingly, a secured creditor would not benefit from the longer period to register and achieve "super-priority" under article 34.

39. By way of illustration, assume that Grantor acquires an item of equipment from Seller on credit on Day 1 and grants Seller an acquisition security right in the item of equipment to secure its obligation to pay the remainder of the purchase price; on Day 5 Seller registers a notice that has the effect of making its acquisition security right effective against third parties. Between those two dates, on Day 3, Judgement Creditor obtains a judgement against Grantor and takes the steps specified in article 35, paragraph 1, to acquire rights in the item of equipment. Under the rule in article 35, paragraph 1, Judgement Creditor's rights would have priority over Seller's security right because Judgement Creditor obtained its rights before Seller's security right was effective against third parties. As a result of the operation of article 38, however, Seller's security right has priority over the rights of Judgement Creditor.

Article 39. Acquisition security rights in proceeds

40. Article 39 is based on recommendation 185 of the Secured Transactions Guide (see chap. IX, paras. 158-172). Both option A and option B of article 36 provide that, under certain circumstances, an acquisition security right has priority over a competing non-acquisition security right in the same encumbered asset even if, under the general priority rule in article 28, the non-acquisition security right would have priority. This article determines whether that "super-priority" over non-acquisition security rights carries over to proceeds of the encumbered assets that are subject to the acquisition security right.

41. Under the general principles of article 10, a secured creditor with a security right in an asset obtains a security right in the identifiable proceeds of that asset and, under the circumstances described in article 19, that security right is effective against third parties. This is equally true of assets subject to non-acquisition security rights and those subject to acquisition security rights. Under the rule in article 30, the priority of the security right in the proceeds is the same as the priority of the security right in the original encumbered asset. Under that rule, the security right in proceeds of assets subject to an acquisition security right would have the same "super-priority" as the security right in the original encumbered asset. Article 39, however, limits the reach of article 30 by extending "super-priority" to proceeds only of certain types of assets subject to an acquisition security right (option A) or by not extending the "super-priority" to proceeds at all (option B).

42. Under option A, the "super-priority" with respect to the assets subject to the acquisition security right always carries over to the proceeds of those assets, except when the assets subject to the acquisition security right consist of inventory, consumer goods or their intellectual property equivalent. When the asset subject to the acquisition security right is inventory or its intellectual property equivalent, whether the "super-priority" carries over to proceeds depends on the nature of the proceeds. If the proceeds are receivables, negotiable instruments, or rights to payment of funds credited to a bank account, the "super-priority" does not carry over to those proceeds. If, on the other hand, the proceeds take another form, the "super-priority" does carry over to the proceeds. When the assets subject to the acquisition security right are consumer goods or intellectual property or rights of a licensee under a licence of intellectual property used or intended to be used by the grantor [primarily] for personal, family or household purposes, however, the "super-priority" does not carry over to the proceeds.

43. The primary reason for the decision not to provide "super-priority" for certain types of proceeds in option A relates to the difficulty that would be faced by competing secured creditors with security rights in payment rights in determining which of those payment rights are proceeds of assets subject to acquisition security rights and which are not. As a result, if there were "super-priority" treatment for those types of proceeds, competing secured creditors with security rights in payment rights might simply assume that all of those payment rights are proceeds and, as a result, extend less credit on the basis of them.

44. Option B provides that the "super-priority" with respect to assets subject to an acquisition security right does not carry over to proceeds of those assets under any circumstances, with the result that the priority of the security right in the proceeds will be determined under the general principle in article 28. This option is provided as an option for States that do not wish to make the sort of distinctions between types of proceeds made in option A.

45. As the Model Law does not deal with insolvency-related matters, with the exception of article 33, no article has been included in the Model Law along the lines of recommendation 186 of the Secured Transactions Guide to deal with the application of the special priority rules for acquisition security rights. However, there is nothing in these articles to imply that insolvency law will not operate against the background of secured transactions law and thus that these provisions will not apply to acquisition security rights in the case of insolvency.

Article 40. Acquisition security rights in tangible assets commingled in a mass or product competing with non-acquisition security rights in the mass or product

46. Article 40 deals with situations in which a grantor has granted an acquisition security right in an asset that later becomes part of a mass or product and has also granted a security right in the mass or product. Under article 11, when the original asset becomes part of the mass or product, the secured creditor has a security right in that mass or product. This article provides that the acquisition security right in the mass or product that results from the security right in the separate asset has priority over the security right in the mass or product as original encumbered asset, even if that security right was previously made effective against third parties or was the subject of a pre-registered notice.

Article 41. Subordination

47. Article 41 is based on recommendation 94 of the Secured Transactions Guide (see chap. V, paras. 128-131). Paragraph 1 allows a person to agree to lower priority of its security right as against a competing claimant than would otherwise result from application of the priority rules in this chapter.

48. Such an agreement, usually referred to as a subordination agreement, may be in the form of a bilateral agreement between the party agreeing to lower priority and the competing claimant that will benefit from that agreement; it may also be a unilateral commitment (usually made to the grantor) by the party agreeing to lower priority that its priority will be lower than that of the beneficiaries described in the commitment. Such an agreement is governed by this article so long as it is between a secured creditor and a grantor, between two or more secured creditors or between a secured creditor and another competing claimant (e.g. a judgement creditor or an insolvency representative).

49. Paragraph 2 makes it clear that, as an agreement, a subordination agreement binds only the parties to it and does not subordinate the claims of any other parties. For example, if SC 1, that has a claim for 50, subordinates its claim to SC 3, who has a claim for 70, SC 3 has priority over SC 2 only for 50.

50. In unusual circumstances, subordination can create circular priority issues. For example, assume that SC 1, 2, and 3 each have a security right in the same encumbered asset and their priority, determined under the rules of this chapter, is in that order, so that SC 1's security right is superior to that of SC 2 and SC 2's security right is, in turn, superior to that of SC 3. Then assume that SC 1 enters into a subordination agreement with SC 3, pursuant to which SC 1 agrees to subordinate its priority in favour of SC 3. As a result, SC 3 has priority over SC 1. However, SC 1 (who did not subordinate its priority in favour of SC 2) has priority over SC 2, and SC 2 has priority over SC 3, completing the circle.

Article 42. Future advances, future encumbered assets and maximum amount

51. Article 42 is based on recommendations 97-99 of the Secured Transactions Guide (see chap. V, paras. 135-143). Inasmuch as a security right can secure obligations arising after the conclusion of the security agreement (see art. 7) and a secured obligation can be secured by assets created or acquired after the conclusion of the security agreement (see art. 8), this article clarifies the priority of a security right in such circumstances.

52. Paragraph 1 provides that the priority of a security right is not affected by the time when the obligation it secures was incurred. Thus, a security right has the same priority whether the entire secured obligation was incurred at or before the creation of the security right or whether the security right secures obligations incurred thereafter. Paragraph 2 similarly provides that when a security right has been made effective against third parties by the registration of a notice, the priority resulting from the time of that notice under article 28 is the same whether the encumbered assets were owned by the grantor at the time of registration or acquired thereafter.

53. Paragraph 3, which will be necessary only if the enacting State enacts provisions based on article 6, subparagraph 3(e), and article 9, subparagraph (e) [of

the registry-related provisions*], gives effect to any cap on the secured obligation stated in the notice by providing that the secured creditor's priority is limited by that cap.

Article 43. Irrelevance of knowledge of the existence of a security right

54. Article 43 is based on recommendation 93 of the Secured Transactions Guide (see chap. V, paras. 125-127). A secured creditor's knowledge or lack of knowledge of a competing security right is not relevant to a determination of priority under either the general priority rule in article 28 or any of the special priority rules. The point is made explicit here to emphasize that priority is determined only on the basis of the facts referred to in those articles and not on the basis of difficult to prove subjective states of knowledge. Article 43 applies only to the knowledge of a secured creditor. Under the Model Law, knowledge of other facts is relevant to priority. For example, a buyer of a tangible encumbered asset that has knowledge that the sale violates the rights of a secured creditor with a security right in that asset under the security agreement does not take free of the security right (see art. 32).

B. Asset-specific rules

Article 44. Negotiable instruments

55. Article 44 is based on recommendations 101 and 102 of the Secured Transactions Guide (see chap. V, paras. 154-156). Any drafting changes are intended to ensure that paragraph 1 deals only with the relative priority of conflicting security rights in the same negotiable instrument, while paragraph 2 addresses the rights of a secured creditor with a security right in a negotiable instrument as against a buyer or other consensual transferee of the negotiable instrument.

56. Under paragraph 1, a security right in a negotiable instrument that is made effective against third parties by the secured creditor's possession of the negotiable instrument has priority over a security right in the same negotiable instrument that is made effective against third parties by registration of a notice, without regard to the order in which the security rights became effective against third parties. This is consistent with the important role that possession plays in the law of negotiable instruments.

57. Under paragraph 2, certain buyers or other transferees that take possession of a negotiable instrument take their rights in the instrument free of a security right that is effective against third parties by registration of a notice. If the security right were effective against third parties because of the secured creditor's possession of the negotiable instrument, the buyer or other transferee could not also have possession of it, unless the same agent possesses the negotiable instrument both on behalf of the secured creditor and the buyer or other transferee.

58. More specifically, under paragraph 2, a buyer or other transferee of a negotiable instrument can take free of a security right in that instrument in either of two ways. First, under subparagraph 2(a), a person who becomes a protected holder

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* Reference is to this article as it is contained in document A/CN.9/WG.VI/WP.65/Add.1.

or the like (the enacting State should insert the appropriate term here) of the negotiable instrument under the law of the enacting State acquires its right in the instrument free of an existing security right in it. Second, under subparagraph 2(b), a transferee that takes possession of the instrument and gives value for it without knowledge that the sale or other transfer is in violation of the rights of the secured creditor also acquires its right in the instrument free of that security right. As with the rule in paragraph 1, this rule preserves the important role of possession in the law of negotiable instruments.

59. Knowledge of the existence of a security right does not prevent a buyer or other transferee of a negotiable instrument from acquiring its rights in the instrument free of the security right under subparagraph 2(b) (although such knowledge may prevent the buyer from qualifying as a protected purchaser or the like and, thus, may prevent the buyer from taking free of the security right under subparagraph 2(a)). Rather, only knowledge that the transfer violates the rights of the secured creditor under the security agreement prevents the transferee from acquiring its rights in the instrument free of the security right under subparagraph 2(b). "Knowledge", as defined in article 2, paragraph (r), means "actual knowledge". The reference to "good faith" that was included in recommendation 102, subparagraph (b) has been deleted on the understanding that the absence of knowledge amounts essentially to good faith and the concept of good faith is used in the Model Law only to reflect an objective standard of conduct (see A/CN.9/830, para. 50).

Article 45. Rights to payment of funds credited to a bank account

60. Article 45 is based on recommendations 103-105 of the Secured Transactions Guide (see chap. V, paras. 157-163). It determines the priority between competing security rights in a right to payment of funds credited to a bank account whether those rights to payment are original encumbered assets or proceeds of a security right in other property (which, according to art. 17, para. 1, is automatically effective against third parties, if the security right in the original encumbered asset is effective against third parties).

61. Paragraphs 1-3, taken together, result in the conclusion that a security right in a right to payment of funds credited to a bank account made effective against third parties by any of the methods provided for in article 24 has priority over a security right made effective against third parties by registration of a notice. Under paragraph 1, a security right in a right to payment of funds credited to a bank account that is made effective against third parties by the secured creditor becoming the account holder has priority over all competing security rights in the same asset. Next in priority order, paragraphs 2 and 3 give priority to: (a) a security right in a right to payment of funds credited to a bank account with respect to which the secured creditor is the depositary institution; and (b) a security right made effective against third parties by a control agreement. Under paragraph 4, if there are more than one control agreements, priority is determined on the basis of the order of conclusion of the control agreements.

62. Under paragraph 5, except when the secured creditor has become the account holder, a security right in a right to payment of funds credited to a bank account is subordinate to the depositary institution's rights under other law to set off claims against the grantor against its obligations to the grantor with respect to the grantor's

right to payment of funds from the bank account. This rule protects depositary institutions from losing their rights of set-off without their knowledge or consent.

63. Under paragraph 6, a transferee of funds from a bank account pursuant to a transfer initiated or authorized by the grantor acquires its rights free of a security right in the right to payment of funds credited to the bank account so long as the transferee does not have knowledge that the transfer violates the rights of the secured creditor under the security agreement. A "transfer of funds" includes transfers by a variety of mechanisms, including by cheque and electronic means. The purpose of paragraph 6 is to preserve the free negotiability of funds.

64. Knowledge of the existence of a security right does not prevent a transferee of funds from the bank account from taking free of the security right. Rather, it is only knowledge that the transfer violates the rights of the secured creditor under the security agreement that prevents the transferee from taking free. "Knowledge", as defined in article 2, paragraph (r), means "actual knowledge". Paragraph 7 is intended to preserve the rights of transferees of funds credited to a bank account under other law to be specified by the enacting State.

Article 46. Money

65. Article 46 is based on recommendation 106 of the Secured Transactions Guide (see chap. V, para. 164). Its purpose is to preserve negotiability of money. Thus, under paragraph 1, a transferee of encumbered money acquires its rights in it free of the security right, unless it has knowledge that the transfer violates the rights of the secured creditor under the security agreement. "Knowledge", as defined in article 2, paragraph (r), means "actual knowledge". Paragraph 2 is intended to preserve the free negotiability of money.

Article 47. Negotiable documents and tangible assets covered

66. Article 47 is based on recommendations 108 and 109 of the Secured Transactions Guide (see chap. V, paras. 167-169). It is designed to preserve current practices under which rights to the tangible assets covered (or represented) by a negotiable document are subsumed in the negotiable document with the result that parties that deal with the document generally need not concern themselves separately with claims to the assets not reflected in the document. Accordingly, under paragraph 1, a security right in a tangible asset made effective against third parties by possession of the negotiable document covering that asset is given priority over a competing security right made effective against third parties by any other means.

67. Paragraph 2 states an exception to that general rule. Except when the encumbered asset is inventory, it provides that the rule in paragraph 1 does not apply against a secured creditor that had a security right in an encumbered asset before the earlier of the time that either the asset became covered by the negotiable document or the time that an agreement was concluded between the grantor and the secured creditor in possession of the negotiable document providing that the asset was to be covered by a negotiable document so long as the asset actually became covered by such a negotiable document within the time to be specified by the enacting State.

Article 48. Intellectual property

68. Article 48 is based on recommendation 245 of the Intellectual Property Supplement (see paras. 193-212). The purpose of this article is to clarify that the rule in article 32, paragraph 6, does not obviate other rights of the secured creditor as an owner or licensor of the intellectual property that is the subject of the licence. This clarification is of particular importance because the concept of "ordinary course of business", used in article 32, paragraph 6, is a concept of commercial law and is not drawn from law relating to intellectual property law and thus may create confusion in an intellectual property financing context. Typically, law relating to intellectual property does not distinguish in this respect between exclusive and non-exclusive licences and focuses rather on the issue whether a licence has been authorized or not.

69. As a result, unless the secured creditor authorized the grantor to grant licences unaffected by the security right (which will typically be the case as the grantor will rely on its royalty income to pay the secured obligation), the licensee would take the licence subject to the security right. Thus, if the grantor defaults, the secured creditor would be able to enforce its security right in the licensed intellectual property and sell or license it free of the licence. In addition, a person obtaining a security right from the licensee will not obtain an effective security right as the licensee would not have received an authorized licence and would have no right in which to create a security right.

Article 49. Non-intermediated securities

70. Article 49 covers a topic not addressed in the Secured Transactions Guide, which excluded from its scope all types of securities (see rec. 4, subpara. (c)). So as not to interfere with existing customs and practices with respect to non-intermediated securities, this article adjusts the general priority rule of article 27 in a manner similar to the special priority rules for security rights in negotiable instruments and rights to payment of funds credited to a bank account.

71. For certificated non-intermediated securities, paragraph 1 provides that a security right made effective against third parties by the secured creditor's possession of the certificate has priority over a competing security right by the same grantor that is made effective against third parties by registration of a notice in the Registry. This is parallel to the rule for negotiable instruments in article 44, paragraph 1.

72. For uncertificated non-intermediated securities, paragraph 2 provides that either the notation of the security right or the registration of the name of the secured creditor as the holder of the securities in the books maintained for that purpose by or on behalf of the issuer has priority over a security right in the same securities made effective against third parties by any other method. This rule is similar to the rule for rights to payment of funds credited to a bank account in article 45, paragraph 1. The rationale for this rule is that such notation or registration in the books of the issuer fulfils a similar function to the secured creditor becoming the account holder of a bank account.

73. Paragraphs 3 and 4 are also applicable only to uncertificated non-intermediated securities. They parallel the similar rules for rights to payment of funds credited to a bank account in article 45, paragraphs 3 and 4. Paragraph 3 gives

priority to a security right made effective against third parties by conclusion of a control agreement over other security rights in the same securities. As between security rights made effective against third parties by conclusion of a control agreement, paragraph 4 awards priority in the order in which those control agreements were concluded.

74. Paragraph 5 is intended to preserve the rights of transferees of non-intermediated securities under other law to be specified by the enacting State. It parallels article 45, paragraph 7.