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Draft Practice Guide to the UNCITRAL Model Law on Secured Transactions

Note by the Secretariat

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II. How to engage in secured transactions under the Model Law (*continued*)

B. A key preliminary step for secured financing: due diligence

1. A reasonable lender needs to examine and verify a number of aspects before entering into a secured financing arrangement. These preliminary steps (referred to generally as "due diligence" in this Guide) ensure that the loan is effectively secured. Though not a legal requirement under the Model Law, due diligence would ascertain, uncover and allow the lender to address in advance any risks inherent to the anticipated transaction. As the focus of this Guide is on secured transactions, this section does not address diligence to be conducted with regard to unsecured lending or lending in general.

2. The appropriate level of due diligence would depend on various factors, including who the borrower or the grantor is, the type of secured transaction, and the type of asset. Diligence on the grantor may entail examining whether there are any laws or regulations that restrict the enforcement of a security right. If the creditor is financing the acquisition of an asset, it would need to assess whether there are any potential security rights and how to obtain priority over them.

3. Lenders may also be tempted to take a security right in all of the grantor's assets as conducting due diligence can be costly and time-consuming. In practice, the related costs may be transferred to the grantor. Nonetheless, this section explains why it is advisable for lenders to undertake due diligence, in a cost- and time-effective manner.

4. Lenders may conduct due diligence by engaging the service of a third-parties. For example, credit bureaus may be used to assess the credit of a borrower and industry analysts may be used to explore the strengths and weaknesses of the industry in which the borrower operates. Lenders may hire field examiners to inspect and evaluate the borrower's premises, books and records and appraisers to evaluate the value of different types of assets to be encumbered.

5. A lender will often begin due diligence by sending a checklist, questionnaire or certificate to be completed by the grantor. Annex AA provides a sample ("Sample Diligence Certificate"), which lists some essential information that a lender would generally request from the grantor as a basis for its due diligence.

6. Due diligence should not be confined to the outset of a loan transaction. It should be conducted throughout the entire duration of the financing arrangement. For example, secured creditors may engage third parties to monitor the status of collateral during the entire period (on the need for continued monitoring, see section F below).

1. Due diligence on the grantor

7. Due diligence on the grantor is an important step to take before engaging in any secured transaction. However, much of that diligence would overlap with the diligence conducted by a lender in connection with the granting of an unsecured loan.

8. Section 1 of the Sample Diligence Certificate elicits general information relating to the grantor. For example, the accurate name(s) of the grantor is requested, which is critical to assure that searches of the Registry and notices to be registered reflect the correct name. Lenders would want to make sure that there aren't any other names attributed to the grantor, which may reveal potential competing security rights in the assets to be encumbered.

9. Other sections of the Sample Diligence Certificate elicit information about the grantor, including the place of central administration, any material contracts to which it is a party, list of pending or potential litigations, outstanding tax obligations, employee benefits as well as officers of the company, all of which can assist the lender in conducting due diligence.

2. Due diligence on the assets to be encumbered

10. Much of the due diligence will relate to the assets to be encumbered. Section 3 of the Sample Diligence Certificate elicits information about such assets. Based on the information provided by the grantor, a lender would usually (i) identify the assets of the grantor and verify their existence; (ii) verify that the grantor has rights in those assets or the power to encumber them; (iii) determine their potential value (including whether they are adequately insured); and (iv) examine any conflicting security rights or other claims in those assets.

Identifying the assets and verifying their existence

11. The assets to be encumbered will usually be readily identifiable. However, when the loan is to be secured by substantially all present and future assets of the grantor, it would be necessary for the lender to understand and identify the different types of assets to ensure that it obtains an enforceable security right in all of the assets.

12. Though it may seem obvious that a lender would verify the existence of the assets to be encumbered, some of the greatest frauds have arisen where the assets did not exist at all. There are many ways to verify the existence of the assets. The existence of inventory and equipment can be verified by a physical inspection. Sections 2 and 3 of the Sample Diligence Certificate thus elicits information on the location of such assets. An examination of the documents on file in an intellectual property registry can verify the existence of intellectual property rights. In the case of receivables, the lender may contact the debtors on the receivables to verify that the goods or services covered by the receivables were, in fact, delivered and that the debtor acknowledges that it owes the full amount of the receivable to the borrower.

Verifying the grantor's rights in the assets

13. For an effective security right to be created, the grantor must have rights in the asset or the power to encumber it. It is therefore important for a lender to verify that these requirements are met with respect to each asset to be encumbered. Furthermore, lenders would need to assess the extent to which such rights or power of the grantor would serve as appropriate security for its loan.

14. Lenders would need to rely on a number of sources to verify that the grantor owns, has other rights or has the power to create a security right over the assets. While the methods will vary depending on the type of asset, the methods mentioned above to verify the existence of the assets may also be applied. In the case of equipment or inventory, the lender can examine the purchase orders issued by the grantor to the suppliers of these assets as well as the invoices from the suppliers. In the case of a bank account, lenders can use the names and addresses of the depositary bank as well as account information provided by the grantor along with bank statements if available. For assets that are registered in a specialized registry (such as intellectual property), the lender could determine whether the grantor was in the chain of title to the intellectual property. Otherwise, the lender may examine documents evidencing the grantor's rights to the intellectual property, such as license agreements or patent grants.

Determining the value of the assets

15. A lender should have a good understanding of the value of the collateral. Valuation would differ depending on the type of asset and how the lender would eventually enforce its security right. For example, if the collateral were inventory, it is likely that the creditor would eventually dispose of the asset, so its value on the secondary market would form the basis of valuation. If the collateral were receivables, valuation may be based on the amount which the secured creditor is expected to collect from the debtors of the receivable. A prudent lender would also take into account how much it will likely recover if the collateral must be disposed of under conditions of a forced sale.

Example #13: Company X sells kitchen appliances to restaurant owners. Many of its sales are on credit, with the customers paying for the appliance over a period of time, so Company X needs operating funds from time to time to pay its ordinary expenses. Bank Y is prepared to advance funds by setting up a line of credit that Company X can draw on when it needs funds, as long as Bank Y is given security over all of Company X's existing and future receivables and inventory. Collections on the receivables would be used to pay down the line of credit.

16. In example #13, Bank Y will typically make loans only against inventory and receivables that are determined to have value. The criteria relating to receivables may relate to the payment history of the restaurant owners, whether the receivables owed by a certain restaurant owner represent an uncomfortably high percentage of all of the Company X's receivables, and the creditworthiness of the restaurant owners. The criteria relating to inventory may relate to the stage in the manufacturing process in which the goods are found. For example, raw materials and finished goods would typically be more marketable than goods in the process of being manufactured. If Bank Y were to take a security right over all assets of Company X, Bank Y may wish to also take into account the value of Company X's income stream as a whole.

Determining whether the assets are adequately insured

17. A security right in an encumbered asset extends to its identifiable proceeds, so insurance proceeds could serve as a substitute for the collateral. Though there is no requirement in the Model Law that the risk of loss or damage to the collateral be covered by an insurance policy, a prudent lender may want to ensure that the collateral is adequately insured, particularly when insurance policies are readily available. There are some instances, however, such as in the cases of micro-enterprises, when insurance policies may not be readily available.

18. A lender would ensure that the amount for which the encumbered assets are insured accurately reflects the value of such assets. The lender may also consider incorporating into the security agreement a clause, countersigned by the insurer, stating that the insurance proceeds are payable directly to the lender in case of grantor´s default. Another option would be for the lender to include insurance proceeds as original collateral in the security agreement, as this would avoid complexities that may arise when claiming its security right over the insurance payments.

Ascertaining the existence of competing security rights in, or other claims with respect to, the collateral

19. As an important step in conducting due diligence, lenders would determine whether there are any competing security rights or other claims. Security rights can be made effective against third parties by registering a notice in the Registry and the order of registration generally determines the order of priority among competing security rights. Therefore, a lender should conduct a search of the Registry to ascertain whether there are any existing security rights that may have priority (on how to search, see section C below).

20. Some States require that the maximum amount for which a security right can be enforced is set forth in the notice (article 8(e) of the Model Registry Provisions) as a way to facilitate secured lending by subsequent creditors. As part of due diligence, a lender should ascertain whether the encumbered asset would still have some residual value after satisfaction of prior-registered secured creditor.

21. There are other means to make a security right effective against third parties, including by obtaining possession of the asset and by concluding a control agreement (for bank accounts and uncertificated non-intermediated securities). Consequently, even if a search of the Registry does not disclose any prior-registered security rights, a lender should verify that the grantor is in physical possession of the asset and remains in possession while the lender registers a notice of its security right.

Similarly, a lender taking security over a bank account may need to inquire whether there exists a security right in favour of the deposit-taking bank and whether there exists a control agreement in favour of another secured creditor.

22. Some enacting States may require security rights in some categories of assets to be registered in specialized registries. If the assets to be encumbered include those that fall within the scope of the Model Law and those subject to registration in such specialized registries, a lender will need to conduct a search of all relevant registries. It will also need to be mindful that its security rights over the assets subject to a different registration regime may not be subject to the provisions of the Model Law, even if they had been covered by the same security agreement.

23. If a search of the Registry reveals no potential competing security right, a lender may still wish to inquire whether the grantor was the original owner of the asset, and if not, how the grantor acquired the asset. This is because the grantor may have acquired the asset subject to a security right that was granted by seller, unless the purchase was made in the ordinary course of the seller's business. It would therefore be prudent for the lender to conduct an additional search in the Registry using the name of the previous owner to avoid the risk of priority disputes. Furthermore, as a security right in an encumbered asset extends to its proceeds, it would be prudent for a lender to inquire whether the assets to be encumbered were proceeds of an asset, which may have been subject to another security right.

24. A creditor who finances the grantor's acquisition of an asset may obtain priority over a prior-registered creditor with a security right in future assets of the same kind. Thus, a lender who has registered its security right over the grantor's future assets should still conduct a search of the Registry before extending credit based on new assets acquired by the grantor. A search of the Registry would allow the secured creditor to assess whether it would continue to have priority over those new assets.

25. A lender should also typically require grantors to disclose the existence of preferential claims, which may have an impact on the priority of it security right (see section 8 and 9 of the Sample Diligence Certificate). As a general point, a lender should be aware of the rules on priority competitions in the Model Law as part of its due diligence (see section G below).

Measures to be taken when there are competing security rights

26. When due diligence reveals that there are potential competing security rights or claims over the assets to be encumbered, a lender may take a number of appropriate measures.

27. For example, it may inquire with the grantor on the existence of a registered notice and may request the grantor to provide a different asset as collateral. It may also request the grantor to obtain a release agreement from the secured creditor on record, particularly if the registered notice is overly broad and describes assets not covered by the underlying security agreement. The secured creditor on record could be contacted and asked to register an amendment notice. If the underlying secured obligation has been paid in full or if the underlying security agreement had not been concluded, the secured creditor on record may be asked to register a cancellation notice or to subordinate its priority depending on the circumstances.

28. In order to have priority over a pre-registered security right, a lender, before proceeding further with the loan, may request that the secured creditor on record subordinate the priority of its rights or conclude a subordination agreement. If the new loan will be used to repay the underlying secured obligation, the lender may obtain a "pay-off" letter from the secured creditor on record stating the amount that is still owed and disburse the amount directly to that secured creditor. This may also apply when there are delinquent taxes to be paid by the grantor. Tax authorities in some States may be willing to enter into a subordination agreement with the understanding that the outstanding tax amount will be paid out of the new loan.

29. The lender may also decide to change the terms of the loan agreement reflecting the potential risks or eventually terminate the proposed transaction entirely.

[*Note to the Working Group: The Sample Diligence Certificate is presented below to facilitate the consideration by the Working Group. Upon finalization of the draft Practice Guide, it will be presented at the end of the Practice Guide in the Annex*]

Annex I

Sample Diligence Certificate

The grantor would usually be asked to complete a checklist or certificate that lists some essential information to form the basis of due diligence. The following provides one such example of a certificate and is not intended to be a standard or model. The sample diligence certificate would need to be adjusted depending on the borrower/grantor and assets to be encumbered. It would be prudent to request the same information from any co-borrowers or guarantors.

TO BANK OF THE WEALTH,

The undersigned, **MODERN TECHNOLOGIES INC**. (the "Company") hereby represents and warrants to you as follows:

1. General information relating to the Company

(a) The name of the Company as it appears in its current organizational documents: [_____]
(b) Organizational identification number: [_____]
(c) Tax identification number: [_____]
(d) Jurisdiction of formation: [_____]
(e) Other jurisdictions where the Company is duly qualified to conduct business: [_____]
(f) All other names (including fictitious, trade and similar names) currently being used by the Company or used in the past: [_____]
(g) Names and addresses of all entities which have been merged into the Company: [_____]
(h) Names and addresses of all entities from whom the Company has acquired any movable asset through a transaction not in the ordinary course of that entity's business along with the date of acquisition and the type of movable asset: [_____]

* Attached are copies of all organizational and related documents of the Company.

2. Location of the Company

(a) Current address of the place of central administration of the Company: [_____]
(b) Addresses of other locations where the Company maintains or stores any inventory, equipment or other assets: [_____]

3. Information about assets of the Company

(a) Types of assets with a detailed schedule describing each asset and their location

Motor vehicles	Yes ☐ No ☐
Equipment	Yes ☐ No ☐
Inventory (raw material and finished goods)	Yes ☐ No ☐
Receivables	Yes ☐ No ☐
Registered copyrights, patents, trademarks and relevant applications	Yes ☐ No ☐
Unregistered copyrights	Yes ☐ No ☐
Licenses to use trademarks, patents and copyrights	Yes ☐ No ☐
Promissory notes and other negotiable instruments	Yes ☐ No ☐
Equipment leased by the Company	Yes ☐ No ☐
	Yes ☐ No ☐

	Yes ☐ No ☐
	Yes ☐ No ☐

(b) Banks and other financial institutions at which the Company maintains a deposit account, securities account or commodity account:

Name of bank	Address	Account information

4. Material contracts

[A list of material contracts which the Company is a party]

* Attached are copies of:

- loan and other financing agreements, inter-creditor agreements and guarantees with a schedule of all outstanding obligations thereunder or in respect thereof
- mortgages, deeds of trust, pledges and security agreements
- lease agreements relating to real property
- agreements regarding mergers and acquisitions, whether or not consummated
- all other contracts in which the Company has an interest

5. Encumbrances

[A list of property subject to the liens or encumbrances]

Name of Holder of Lien/Encumbrance	Description of property

6. Litigations[1]

A list of litigations to which the Company is involved, including:

- pending and potential litigation or claims involving amounts claimed against the Company in an indefinite amount or in excess of $50,000 for each case;
- administrative, governmental or regulatory investigations or proceedings; and
- claims other than claims on accounts receivable, which the Company is asserting or intends to assert, and in which the potential recovery exceeds $50,000 for each case.

7. Affiliate transactions[2]

[A list of transactions between the Company and its affiliates]

* Attached are copies of any agreements, including any tax-sharing agreements and loan agreements the affiliates

8. Tax related information[3]

(a) Tax assessments currently outstanding and unpaid by the Company

Tax authority	Description	Amount due

[1] An analysis of the pending or potential litigations and claims can yield valuable information as to potential financial risks to which the company may be exposed, as well as how the company conducts its business. A lender may also wish to make further inquiries with the bankruptcy and insolvency officials to ensure that insolvency proceedings have not been commenced.

[2] It would be important to verify that such transactions are conducted on an arms-length basis, and do not represent a potential source of self-dealing by the company.

[3] In some States, certain claims may be given priority even over prior-registered security rights without the need for registration. Examples of common preferential claims are claims by the tax authorities for unpaid taxes and other assessments and claims by employees for unpaid wages and other benefits. The lender should determine what preferential claims are recognized in their jurisdiction and those that may exist against the grantor.

(b) Any pending audits or potential disputes with tax authorities: [_____]

* Attached are copies of the Company's tax filings for the past five years.

9. Employee benefits

[A list of benefits provided by the Company to its employees]

* Attached are copies of the employee pension benefit plan, revenue or profit-sharing plan, multi-employer plan or other pension.

10. Insurance

Insurer and policy number	Description of insurance policy	Type of coverage and limitations

11. Directors, managers and other officers of the Company

Title	Name

12. Miscellaneous

- Indebtedness: [List of any current indebtedness of the Company that is to be paid off at the closing of the loan, including each creditor's name, a contact person and contact details, and the approximate amount of such indebtedness]

* Attached are copies of the documentation for the Company's existing indebtedness that will remain in place after the closing of the loans.

- Necessary consents: [List of any consents or approvals required in connection with the closing of the loans]
- Regulatory and licensing matters: [Any regulatory/licensing compliance required of the Company due to the specific nature of its business and any notifications received by the Company for non-compliance with applicable law or regulation]

13. Legal counsel representing the Company

Name of attorney	Affiliation	Telephone	Email

The Company agrees to advise you of any change or modification to any of the foregoing information or any supplemental information provided on the exhibits or attachments hereto and, until such notice is received by you, you shall be entitled to rely on the information contained herein and on the supplemental

information provided on such exhibits and attachments and presume that all such information is true, correct and complete.

18 October 2018

MODERN TECHNOLOGIES INC
By:
Name:
Title:
Email:
Phone: _____

C. Searching the Registry

1. Why search in the Registry?

30. As illustrated in section B above, a prospective secured creditor would usually conduct a search of the Registry as part of its due diligence to ascertain whether there are any competing security rights. A secured creditor should also conduct a second search of the Registry immediately after registration to ensure that the notice has been properly registered and that the priority of its security right is preserved. Following the second search, the secured creditor can disburse funds without worrying that a third party may obtain a higher-ranking security right by registering an intervening notice in the Registry.

31. It is not only prospective secured creditors that would conduct a search of the Registry. Anyone who has, or plans to obtain, an interest in an asset should conduct a search of the Registry to ensure that they are not adversely affected by a security right in that asset.

32. For example, if a person intends to purchase a tangible asset from a seller, which is not in the business of selling such assets, the prospective buyer may wish to conduct a search of the Registry to ensure that its rights would not be subject to a security right granted by the seller or any previous owner of the asset. It would be prudent for a prospective buyer to conduct a search using the name of the seller and prior owners. This may, however, not be necessary in States that require a secured creditor to register an amendment notice adding the name of the buyer before the expiry of the prescribed grace period in order for its security right to be effective against the buyer (see section E below). In such circumstances, a search of Registry under the current owner (the seller) would suffice. Nonetheless, a search of the Registry under previous owner may still be prudent to avoid unnecessary priority disputes.

33. A creditor that has obtained a judgement against the grantor or the insolvency representative of the grantor may also wish to conduct a search of the Registry to ensure that its rights are adequately protected. Those with preferential claims (claims arising by operation of other law, which have priority over registered security rights), may also wish to conduct a search to be aware of any competing security rights in the assets.

34. In summary, under the Model Law, any person may submit a search request to the Registry to verify the existence of a potential competing security right as long as the prescribed search request form is used and the prescribed fees paid, if any.

2. How to search in the Registry?

Search criteria

35. In most cases, searches of the Registry would be conducted using the name of the prospective grantor, but other identifiers of that person or the registration number of the notice assigned by the Registry can also be used. The grantor will usually be the debtor (the person owing the obligation) but a person other than the debtor may

also grant a security right in its assets to secure an obligation owed by the debtor. In that case, the search should be conducted using the name of the person granting the security right and not the debtor. However, a prudent lender will often conduct an additional search against the name of the debtor (including a guarantor of the secured debt) as part of its overall assessment of the debtor's creditworthiness.

[*Note to the Working Group: The Working Group may wish to consider reproducing the sample search request form in Annex II of the Registry Guide (p. 150) here or inserting a hyperlink to that form.*]

How to determine the correct name for searching?

36. As illustrated in section B, a prospective secured creditor would usually elicit the name and other identifiers of the grantor as part of its due diligence. This is particularly important because searchers are responsible for using the correct name when conducting searches. The correct name is determined by reference to official documents or public record as specified by the enacting State. Therefore, a searcher may wish to obtain a copy of the specified official document or public record before conducting a search. Individuals may be hesitant in providing their official documents (for example, to the grantor's judgment creditors). In such case, searchers should use all conceivable names of the grantor.

Exact or close match search results

37. In States that opt for an "exact match" system, a search will only reveal notices that contain information that matches the search criterion exactly (article 23 of the Registry Provisions, option A). Other States may seek to protect secured creditors against the risk posed by minor errors in entering the grantor's name when conducting a search. In such States, search results disclose not only "exact matches" but also "close matches", in other words, notices in which the name of the grantor closely matches the name entered by the searcher (article 23 of the Registry Provisions, option B). By providing "close match" results, a searcher may be able to find a relevant notice despite having made an error in entering the correct name of the grantor.

38. Under both options, searchers should take caution to ensure that they use the correct name of the grantor to ensure a reliable search result. In a "close match" system, searchers should determine whether the search result reveals any notice relating to the prospective grantor and whether the assets described in those notices are relevant for the proposed transaction.

[*Note to the Working Group: The Working Group may wish to consider reproducing the sample search result form in Annex II of the Registry Guide (p. 151) here or inserting a hyperlink to that form.*]

What if the grantor recently changed its name?

39. If the grantor has recently changed its name, a search of the Registry using the new name might not reveal any notice, although there may have been notices registered under the prior name. Thus, a secured creditor should inquire whether there has been a change in the name of the grantor (see section 1 of the Sample Diligence Certificate). One way to verify this may be conducting a search of the public business records when the grantor is a legal entity.

40. If a change has occurred and the grace period for registering an amendment notice has not yet expired, the secured creditor should conduct an additional search using the prior name of the grantor to check if there are any competing security rights registered under that name (on what the secured creditor on record would need to do, see section E below).

D. Preparing the security agreement

41. As the Model Law adopts a functional approach to the concept of a security right, the term "security agreement" should be understood to include not only agreements creating a security right in assets owned by the grantor but also sale contracts on retention-of-title terms and financial lease agreements (see examples #5A to #5D in section A). In addition, as the Model Law generally applies to outright transfers of receivables, the term "security agreement" should be understood to include agreements whereby a person sells or otherwise disposes of receivables for non-security purposes. Annex II provides one such example of a security agreement (the "Sample Security Agreement").

1. Legal requirements for a security agreement

42. In illustrating how to take an effective security right, section A has already touched upon the basic requirements of a security agreement. A security agreement must be in writing and signed by the grantor. An exception to the "writing" requirement is that the security agreement may be oral if the secured creditor is in possession of the encumbered asset. However, even when the secured creditor is in possession of the encumbered asset, parties would usually document their agreement in writing to avoid a dispute as to the exact terms of their agreement (see example #2 in section A above).

43. The Model Law prescribes very few additional requirements for a security agreement to create a valid security right. The security agreement must identify the parties (the secured creditor and the grantor), describe the secured obligation, and describe the assets to be encumbered. The description of the secured obligation and of the encumbered assets must be in a manner that reasonably allows their identification.

44. A security right can be created not only in a specific asset (for example, the grantor's van) but also in assets of a generic category (for example, all of the grantor's vehicles or inventory) and in all of the grantor's movable assets. A description in that manner would be sufficient to reasonably identify the encumbered asset. As a security right can also be created over future assets, the security agreement would need to describe such assets in broadly inclusive term (see example #3 in section A). Where the security right secures a line of credit made available by the secured creditor to the grantor for the purposes of financing the business of the grantor, it is typical that the security agreement would describe encumbered assets as consisting of all present and future movable assets of the grantor (see example #4 in section A and section 2.1 of the Sample Security Agreement).

45. A security right may secure an existing or future obligation, which may be specifically identified in the security agreement, or all obligations owed to the secured creditor at any time. In the latter case, it is sufficient for the security agreement to state the secured obligation in such fashion and no further description is necessary (see sections 1(d) and 2.2 of the Sample Security Agreement).

46. Some States may require that the security agreement indicate the maximum amount for which the security right may be enforced (see article 6(3)(d) of the Model Law). In such a case, a secured creditor should ensure to indicate the maximum amount in the security agreement and to ensure that the amount is sufficient to recover what it is owed upon enforcement of its security right.

2. Practical considerations

47. A security agreement will be a very short if it includes only the minimum requirements under the Model Law. However, the parties will usually include other provisions elaborating on the terms of their agreement. Moreover, the structure and content of a security agreement would be substantially different depending on the nature of the transaction. In practice, a secured creditor would usually prepare a draft

of the security agreement or use a template for review and comments by the grantor before an agreement is concluded by the parties.

48. The Sample Security Agreement involves a transaction where a lender is extending a line of credit to a borrower and the obligation of the borrower to repay is secured with all of its present and future assets. If the transaction related to a loan made to finance the purchase of an equipment and secured by that equipment, the description of the encumbered asset in the security agreement would be limited to that equipment.

49. Parties are allowed to vary by agreement the provisions of the Model Law to a certain extent (referred to as "party autonomy"). For example, the contractual rights and obligations of the parties are determined by the terms and conditions set out in the security agreement. These terms may relate to the monitoring of the encumbered assets as well as the enforcement by the secured creditor upon the occurrence of default, to the extent that they are not inconsistent with the provisions of the Model Law (see sections 3 to 6 of the Sample Security Agreement).

50. The parties are also free to determine in the security agreement what constitutes or triggers default. Events of default will typically include the following:

- The failure by the grantor to pay when due any amount owing under the secured obligations;
- The failure by the grantor to make a payment to another creditor in respect of a monetary obligation that exceeds a certain threshold (referred to as a "cross-default");
- The insolvency of the grantor or any of the encumbered assets being the subject of a seizure or enforcement measures or proceedings by a third party;
- Any representation made by the grantor in the agreement or any document delivered to the secured creditor pursuant to the agreement being false or misleading in any material respect; and
- Any non-performance in any material respect by the grantor of any of its obligations under the agreement.

51. Where the grantor is not the debtor of the secured obligations, events of default should be drafted to include the debtor when applicable. In most cases, these events will be considered to constitute an event of default only after the expiry of a grace period.

52. The events of default may also be listed in another agreement which the security agreement would refers to. If the security right is created by an agreement whereby the secured obligations also arise (for example, a sales contract with a retention-of-title clause and financial lease agreements), it is likely that the events of default will be specified in the security agreement. However, where the security right is granted to secure obligations arising under a separate agreement (for example, a credit agreement for a line of credit or a specific loan), it is likely that the security agreement would refer to the separate agreement, which would describe the events of default (see section 1(c) of the Sample Security Agreement).

53. Parties should also be mindful that there may be other laws that may limit the scope of party autonomy (for example, consumer protection law or the law of obligations stating that a default must be material to give rise to acceleration of a term loan).

54. Annex III contains a sample retention-of-title clause and relevant provisions ("Sample Retention-of-Title Clauses"). They are quite different in structure from the Sample Security Agreement provided in Annex II. These clauses may be used in transactions such as contracts of sale where the seller retains title in the assets until the buyer makes full payment of the purchase price (see example #5A in section A). While parties are free to conclude a stand-alone retention-of-title agreement, it is more likely that similar clause are included in another agreement. The precise terms

would vary according to the circumstances, for example when the assets are to be used as equipment or as inventory for resale. The Sample Retention-of-Title Clauses address a situation where the asset is not intended for resale.

55. It may be useful to note that as the Model Law is based on a unitary approach, a seller would not obtain greater protection by using a retention-of-title clause than that provided to a secured creditor. The seller would still need to meet other requirements in the Model Law to make its right effective against competing security rights.

[*Note to the Working Group: The Sample Security Agreement and the Sample Retention-of-Title Clauses below are presented here to facilitate the consideration by the Working Group. Upon finalization of the draft Practice Guide, they will be presented at the end of the Practice Guide in the Annex.*]

Annex II

Sample security agreement for a line of credit

SECURITY AGREEMENT

between

MODERN TECHNOLOGIES INC., a corporation constituted under the *Corporations Act* of State A, having its registered office and place of central administration at [address, State A] (the "**Grantor**")

and

BANK OF WEALTH, a bank constituted under the *Financial Institution Act* of State A, having a branch at [address, State A] (the "**Secured Creditor**")[4]

Preamble

A. The Secured Creditor has agreed to make available to the Grantor a line of credit to finance the operations of the Grantor pursuant to a credit agreement[5] dated 18 October 2018.

B. The execution of this agreement is a condition to the extension of credit by the Secured Creditor to the Grantor under that credit agreement.

1. Definitions

In this agreement:

(a) "Credit Agreement" means the credit agreement referred to in the Preamble, as same may be amended, supplemented or restated from time to time;

(b) "Encumbered Assets" has the meaning given to that term in Section 2.1 below;

(c) "Event of Default" means (i) any event that constitutes an "event of default" under the Credit Agreement, and (ii) any failure by the Grantor to comply with any of its obligations under this agreement;

(d) "Obligations" means all present and future obligations of the Grantor to the Secured Creditor under or contemplated by the Credit Agreement and this agreement;

(e) Each of the following terms has the meaning given to it in the Model Law: "bank account", "control agreement", "debtor of the receivable", "equipment", "inventory", "proceeds" and "product".

[4] The secured creditor and the grantor are identified in the security agreement.

[5] The term "credit agreement" is used as a generic term to describe the agreement under which credit may be extended by the creditor. Other terms may be used depending on the nature of the transaction or local practices.

2. Creation of the security right and secured obligations

2.1 Creation of the security right

The Grantor creates in favour of the Secured Creditor a security right in all present and future movable assets of the Grantor (the "Encumbered Assets").

[The Grantor creates in favour of the Secured Creditor a security right in the following category of assets[6]:

(a) Inventory;
(b) Receivables;
(c) Equipment;
(d) Funds credited to a bank account;
(e) Negotiable documents, including without limitation, bills of lading and warehouse receipts;
(f) Negotiable instruments, including without limitation, bills of exchange, cheques and promissory notes;
(g) Intellectual property and related license rights;
(h) …
(i) To the extent not listed above, all proceeds[7] and products of all of the foregoing.]

2.2 Secured Obligations

The security right hereby created secures all Obligations.

3. Representations of the Grantor[8]

3.1 Location of certain Encumbered Assets

(a) The inventory and the equipment of the Grantor are and will be held or used by the Grantor at all times in State A, unless the Grantor notifies the Secured Creditor of a change, at the addresses listed in the Annex to this agreement;
(b) The billing addresses of the debtors of the receivables owed or to be owed to the Grantor are and will be at all times in State A [, unless the Grantor notifies the Secured Creditor of a change by a notice specifying other State(s) in which debtors of these receivable have billing addresses];
(c) The bank accounts of the Grantor are and will be held at all times at branches of banks in State A, and, unless the Grantor notifies the Secured Creditor of a change, at the addresses listed in the Annex to this agreement. The account agreements relating to these bank accounts are and will be governed by the relevant law of the State in which the applicable branch is located and do not and will not refer to another law for matters relevant to this agreement.[9]

3.2 Location and name of the Grantor

(a) The registered office and the place of central administration of the Grantor are and will be located at all times in State A;
(b) The Grantor's exact name and the State of constitution are as specified on the first page of this agreement. The Grantor will not change its State of constitution without the prior written consent of the Secured Creditor and will not change its name without giving to Secured Creditor a thirty (30) day prior notice of the change.

4. Authorizations relating to the Encumbered Assets

4.1 Registrations

The Grantor authorizes the Secured Creditor to register any notice and to take any other action necessary or useful to make the Secured Creditor's security right effective against third parties by registration.[10]

4.2 Inspection and copies

(a) The Secured Creditor may inspect the Encumbered Assets and the documents or records evidencing same and for such purposes enter into the Grantor's premises, upon giving prior reasonable notice to the Grantor;
(b) At the request of the Secured Creditor, the Grantor will furnish to the Secured Creditor copies of the invoices, contracts and other documents evidencing its receivables.

4.3 Dealings with Encumbered Assets

(a) Until the Secured Creditor notifies the Grantor that an Event of Default has occurred, the Grantor may sell, lease, license or otherwise dispose of its inventory and

documents of title, collect its receivables and negotiable instruments and dispose of worn-out or obsolete equipment, in each case, in the ordinary course of its business;

(b) The Grantor will not grant any security right in the Encumbered Assets and, except as permitted by paragraph (a), will not sell, lease, license or otherwise dispose of the Encumbered Assets;[11]

(c) Unless otherwise agreed between the parties, the Secured Creditor may at any time notify the debtors of the Grantor's receivables of the existence of its security right. However, a notification given prior to the occurrence of an Event of Default will authorize the debtors to make their payments to the Grantor until otherwise instructed by the Secured Creditor following the occurrence of an Event of Default.[12]

5. Undertakings relating to the Encumbered Assets

5.1 Movable assets

The Grantor undertakes that the Encumbered Assets will remain movable assets at all times and will not be physically attached to immovable property.

5.2 Effectiveness of the security right

The Grantor will take all actions and execute all documents reasonably required by the Secured Creditor for the Secured Creditor's security right to be at all times enforceable and effective and enjoy priority against third parties in all jurisdictions where the Encumbered Assets may be located or where the security right may be enforced.

5.3 Bank accounts

The Grantor will take all steps required for the Secured Creditor's security right to be made effective against parties through a control agreement with respect to all funds credited to a bank account held with a bank other than the Secured Creditor.[13]

6. Enforcement

6.1 Rights after an Event of Default

After the occurrence of an Event of Default and to the extent same is continuing:

(a) the Secured Creditor may enforce its security right and exercise all rights of a secured creditor under the Model Law and any other applicable law;

(b) the Secured Creditor may also, subject to any mandatory provision of applicable law;

(i) take possession, use, operate, administer and sell, lease, license or otherwise dispose of any of the Encumbered Assets, in each case, on terms and conditions it deems appropriate;

(ii) collect the Grantor's receivables and negotiable instruments, compromise or transact with the debtors of these receivables and instruments, and grant discharges to them; and

(iii) take all other actions necessary or useful for the purpose of realizing on the Encumbered Assets, including without limitation completing the manufacture of inventory and purchasing raw materials.

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[6] When all present and future assets of the Grantor are intended to be encumbered, the list would not be necessary. The list is provided as an option when the intent of the parties is to limit the security right to certain categories of assets.

[7] While a security right in an encumbered asset extends to its identifiable proceeds, the parties may wish to include such proceeds as part of the original encumbered asset.

[8] This security agreement only includes representations on facts that permit a secured creditor to identify the State whose law will apply to the creation, effectiveness against third parties and priority of a security right. Among other things, the information contained in this section will permit the secured creditor to determine where a registration needs to be made.

[9] This is to ensure the identification of the applicable law under article 97 of the Model Law.

[10] This authorization is required under article 2 of the Model Registry Provisions.

[11] This prohibition is a contractual obligation and is not binding upon third parties. For example, a third party who purchases an encumbered asset may acquire it free of the security right in certain circumstances.

[12] Under the Model Law, a notification to the debtor of a receivable may be given at any time. However, the parties will often include in their security agreement the authorization provided in the second sentence (see article 63(2) of the Model Law).

[13] If funds were deposited with the Secured Creditor, then it will benefit from automatic third-party effectiveness. The Model Law also recognizes control agreements as a method of achieving third-party effectiveness (see article 25 of the Model Law).

6.2 Access to the Grantor's premises
The Grantor permits the Secured Creditor to enter into and use the premises where the Encumbered Assets are located for the purposes of the exercise of the Secured Creditor's enforcement rights.[14]

6.3 Manner of enforcement
The enforcement rights may be exercised on all of the Encumbered Assets taken as a whole or separately in respect of any part of them.

6.4 Reimbursement of expenses
The Grantor will reimburse the Secured Creditor upon demand for all costs, fees and other expenses incurred by the Secured Creditor in the exercise of its rights (including without limitation in the enforcement of its security right), with interest at annual rate of **%.

7. General Provisions
7.1 Additional and continuing security
The security right created by this agreement is in addition to (and not in substitution for) any other security held by the Secured Creditor and is a continuing security that will subsist notwithstanding the payment from time to time, in whole or in part, of any of the Obligations. However, this security right will extinguish when the commitment to extend credit under the Credit Agreement has terminated and all Obligations have been satisfied in full.

7.2 Collections
Any sum collected by the Secured Creditor from the Encumbered Assets prior to all the Obligations becoming due may be held by the Secured Creditor as Encumbered Assets.

7.3 Other recourses
The exercise by the Secured Creditor of any right will not preclude the Secured Creditor from exercising any other right provided in this agreement or by law, and all the rights of the Secured Creditor are cumulative and not alternative. The Secured Creditor may enforce its security right without being required to exercise any recourse against any person liable for the payment of the Obligations or to realize on any other security.

7.4 Inconsistency with the Credit Agreement
In the event of any conflict or inconsistency between the provisions of this agreement and the provisions of the Credit Agreement, the provisions of the Credit Agreement will prevail.

8. Governing Law
This agreement will be governed by and construed in accordance with the laws of State A. The provisions of this agreement must also be interpreted in order to give effect to the intent of the parties that the Secured Creditor's security right be valid and effective in all jurisdictions where the Encumbered Assets may be located and where the rights of the Secured Creditor may have to be enforced.

9. Notices
Any notice by a party to the other must be in writing and given in accordance with the notice provisions of the Credit Agreement.

Counterparts and signatures
This agreement may be executed in any number of counterparts and by each party in separate counterparts and any full set of these separate counterparts will constitute an original copy of this agreement. Delivery of an executed counterpart of a signature page to this agreement by electronic mail will be as effective as delivery of a manually executed counterpart of this agreement.

SIGNED by the parties as of 18 October 2018

MODERN TECHNOLOGIES INC. BANK OF WEALTH

[14] This is a personal obligation of the Grantor and may not necessarily be enforceable against the owner of premises leased to the Grantor, unless the owner consents.

Annex III

Sample retention-of-title clause

The following provides sample clauses for use in a sales contract relating to a specific asset intended to be used by the purchaser in the operation of its business (for example, a printing press).

*. The Asset sold under this contract will remain the property of the Seller until the purchase price has been paid in full. Therefore, the ownership of the Asset will be transferred to the Purchaser only when such payment in full is made to the Seller.

*. The Purchaser authorizes the Seller to register any notice and take any other action necessary or useful to make the Seller's retention of ownership in the Asset effective against third parties by registration.

*. Until ownership of the Asset has been transferred to the Purchaser, the Purchaser will not sell, lease or otherwise dispose of the Asset or grant a security right encumbering the Asset, in each case, without the written consent of the Seller.

*. If the Purchaser sells, leases or otherwise disposes of the Asset in favour of a third party with or without the written consent of the Seller, any receivable arising from that transaction will be automatically subject to a security right in favour of the Seller.[15]

5. The Purchaser will not attach or affix the Asset to immovable property without the prior consent of the Seller.

Annex IV

Glossary

[*Note to the Working Group: The Glossary is presented here to facilitate consideration by the Working Group noting that most of the terms have been referred to in the previous parts of the draft Practice Guide. The Working Group may wish to confirm that the list of terms is complete and that the Glossary is best placed in the Annex to the Practice Guide.*]

To the extent possible, this Guide uses terminology as defined in article 2 of the Model Law. The following list provides clarification on how some of the key terms are used in the Guide. As terminology used in different jurisdictions would likely vary, it is suggested that reference is made to the precise terms used in each State and how they have been interpreted to better understand how the Model Law would operate in that State.

Term	What it means broadly
Acquisition security right	A right that a seller could obtain to secure the buyer's obligation to pay any unpaid portion of the purchase price or a right that a creditor could obtain to secure an obligation owed by the grantor when and to the extent the credit was used to finance the acquisition of an asset.
All asset security right	A security right created over all present and future assets of the grantor.
Borrowing base	An amount that a lender is willing to loan based on the value of the encumbered assets that the borrower provides as security.

[15] As a security right extends to the proceeds of the encumbered asset, this clause reiterates that rule in the Model Law.

Debtor	A person who owes payment or other performance of the secured obligation. In most cases, the debtor would be the person granting a security right, this need not always be the case. A distinction is made with the “debtor of the receivable”, which refers to a person that owes payment of a receivable that is subject to a security right.
Default	The failure of a debtor to pay or otherwise perform a secured obligation. It may also include any other events that the grantor and the secured creditor agreed as constituting default.
Encumbered asset	A movable asset that is provided as security and the term includes receivables that are transferred by agreement for non-security purposes. The term “collateral” is also used to refer to assets subject to a security right.
Equipment	A tangible asset other than inventory or consumer goods that is primarily used or intended to be used in the operation of business. Examples include printing presses or computers used by the grantor in its operation.
Future asset	A movable asset, which does not exist or which the grantor does not have rights in or the power to encumber at the time the security agreement is concluded. Examples include assets that a grantor may purchase, products that it will manufacture and receivables that it will obtain after the conclusion of the security agreement.
Grantor	A person who creates a security right to secure an obligation that it owes, or that is owed by another person. The term also includes a buyer or other transferee of an encumbered asset that acquires its rights subject to a security right as well as a person that transfers receivables for non-security purposes. For ease of reference, the term is used in the Guide to refer also to prospective grantors, those that are in the process of granting a security right over its assets. Depending on the circumstances, the term is used interchangeably with the terms “debtor” or “borrower”.
Inventory	Tangible assets held for sale or lease in the ordinary course of business, including raw materials and work in process.
Movable asset	A tangible or intangible property, which is not immovable property.
Possession	Actual possession of a tangible asset by a person or its representative or by an independent person that acknowledges holding it for that person.
Proceeds	Anything that is received in respect of an encumbered asset, for example, through its sale or other disposition. A computer exchanged as well as money or negotiable instrument received through a sale of a printing press are considered proceeds. Insurance payments due to damages of the assets are also proceeds.
Priority	The right of a person in the encumbered asset in preference to the right of a competing claimant, which may be a secured creditor or any other person with a claim over the asset.

Receivable	A right to payment of a money excluding a right to payment evidenced by a negotiable instrument, a right to payment of funds credited to a bank account and a right to payment under a non-intermediated security.
Secured creditor	A person who has or has the benefit of a security right. The term includes a transferee of receivables for non-security purposes. For ease of reference, the term is used in this Guide to include prospective secured creditors, in other words, creditors that aim to take security over a movable asset. Depending on the circumstances, the term is used interchangeably with the terms “creditor”, “lender”, “financier” or “supplier”.
Security agreement	An agreement between a grantor and a secured party to create a security right. Whether the parties denominate it as a security agreement or not does not matter as the intention of the agreement is to grant a security over a movable asset. This term also includes an agreement that provides for the outright transfer of a receivable.
Security right	A property right in a movable asset, created by a security agreement, that secures payment or other performance of a secured obligation. It includes any right that functions a security purpose regardless of whether the parties have denominated as a security right, and regardless of the type of asset, the status of the grantor or secured creditor, or the nature of the secured obligation. It includes, for example, the right of a seller of a tangible asset on retention-of-title terms and of financial lessors. The term also includes the right of a transferee under an outright transfer of a receivable by agreement.