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Report of the Secretary-General

Addendum

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VII. Priority

A. General remarks

1. The concept of priority and its importance

1. The term "security right", as used in this Guide, refers to an *in rem* right (i.e. a right in property granted to a creditor to secure the payment or other performance of an obligation). The term "priority", on the other hand, refers to the extent to which the creditor may derive the economic benefit of that right in preference to other parties claiming an interest in the same property (see A/CN.9/WG.VI/WP.6/Add.1, para. 14, definition of "priority"). As discussed below, these competing claimants may include holders of consensual security rights in the property, holders of unsecured debt, sellers of the property, buyers of the property, holders of non-consensual security rights in the property (such as security rights arising from judgements or created by statute) and the insolvency representative of the grantor.

2. The concept of priority is at the core of every successful legal regime governing security rights. It is widely recognized that a priority rule is necessary to promote the availability of many forms of low-cost secured credit. Priority makes it possible for grantors to create more than one security right in their assets, thus utilizing the full value of their assets to obtain more credit which is one of the key objectives of any effective and efficient secured transactions regime; see A/CN.9/WG.VI/WP.6/Add.1, para. 27). In addition, to the extent that priority rules are clear and lead to predictable outcomes, creditors, even unsecured creditors, are able to assess their positions in advance of extending credit and to take steps to protect their rights, which reduces the risks to creditors and thereby has a positive impact on the availability and the cost of credit.

3. A creditor will normally extend credit on the basis of the value of specific property only if the creditor is able to determine, with a high degree of certainty at the time it extends the credit, the extent to which other claims will rank ahead of its security right in the property. The most critical issue for the creditor in this analysis is what its priority will be in the event of the grantor's insolvency, especially where the encumbered asset is expected to be the creditor's primary or only source of repayment. To the extent that the creditor has any uncertainty with respect to its priority at the time it is evaluating whether to extend credit, the creditor will place less reliance on the encumbered asset. This uncertainty may increase the cost of the credit to reflect the diminished value of the encumbered asset to the creditor, and may even cause the creditor to refuse to extend the credit altogether.

4. To minimize this uncertainty, it is important that secured transactions laws include clear priority rules that lead to predictable outcomes. The existence of such rules, together with efficient mechanisms for ascertaining and establishing priority at the time credit is advanced, may be as important to creditors as the particulars of the priority rules themselves. It often will be acceptable to a creditor that certain competing claimants have a higher priority, as long as the creditor can determine that it will ultimately be able to realize a sufficient value from the encumbered assets to repay its claim in the event of non-payment by the grantor. For example, a creditor may be willing to extend credit to a grantor based upon the value of the grantor's existing and future inventory, even though the inventory may be subject to

the prior claims of the vendor who sold the inventory to the grantor, or of the warehouseman who stored the inventory for the grantor, as long as the creditor can determine that, even after paying such claims, the inventory may be sold or otherwise disposed of for an amount sufficient to repay its secured obligation in full. Of course, although the focus of the Guide is on consensual security rights, an effective secured transactions law must also include rules for resolving priority conflicts between consensual and non-consensual security rights as well.

5. It is important to note that no matter what priority rule is in effect in any jurisdiction, it will only have relevance to the extent that the applicable conflict-of-laws rules provide that such priority rule governs. This issue is discussed in chapter X (see A/CN.9/WG.VI/WP.9/Add.7, paras. …).

2. Priority rules

6. This section discusses various possible approaches to determining priority. It is important to note that more than one of these rules may effectively coexist in the same legal system insofar as they may apply to different types of priority conflicts.

a. First-to-file priority rule

7. As discussed above (see paras. 2-4), in order to effectively promote the availability of low-cost credit, consideration should be given to establishing priority rules that permit grantors to use the full value of their assets to obtain credit and creditors to determine their priority with the highest degree of certainty at the time they extend credit. As discussed in chapter V (see A/CN.9/WG.VI/WP.9/Add.2, paras. …), one of the most effective ways to provide for such certainty, at least in the case of non-possessory security rights, is to base priority on the use of a public filing system.

8. In many jurisdictions in which there is a reliable filing system, priority is generally determined by the order of filing, with priority being accorded to the earliest filing (often referred to as the "first-to-file priority rule"). In some jurisdictions, this rule applies even if one or more of the requirements for the creation of a security right have not been satisfied at the time of the filing, which avoids the need for a creditor to search the filing system again after all remaining requirements for creation have been satisfied. This rule provides the creditor with certainty that once it files a notice of its security right, no other filing, except for the limited exceptions discussed in section A.3 below, will have priority over its security right. This certainty allows creditors to assess their priority position with a high degree of confidence, and as a result, reduces their credit risk. Other existing or potential creditors are also protected because the filing will put them on notice of the security right, or potential security right, and they can then take steps to protect themselves. Notwithstanding the foregoing, the first-to-file priority rule may not be customary in some cases, such as in the case of purchase money security rights, discussed in section A.3.c. below, or in the case of statutory (e.g. preferential) creditors, discussed in section A.3.f. below.

9. This first-to-file priority rule is illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.6/Add.1, paras. 18 and 23). In these examples, Lender B and Lender C each have a security right in all of Agrico's existing and after-acquired inventory and receivables. Under a first-to-file priority rule, the lender who filed a

notice of its security right in the inventory and receivables first would have priority over the other lender's security right, regardless of the time that all of the other requirements for the creation of each lender's security right have been satisfied.

10. Some jurisdictions provide that, as long as filing occurs within a certain "grace period" after the date on which the security right is created, priority will be based on the date of creation rather than on the date of filing. Thus, a security right that is created first, but filed second, may still have priority over a security right that is created second but filed first, as long as the first security right is filed within the applicable grace period. As a result, until the grace period expires, the filing date is not a reliable measure of a creditor's priority ranking, thus resulting in significant uncertainty. In legal systems in which no such grace periods exist, creditors are not at a disadvantage because they can always protect themselves by making a timely filing. Therefore, in order to avoid undermining the certainty achieved by the first-to-file rule, some jurisdictions restrict the use of grace periods to rare circumstances, applying only to specific situations such as (i) purchase money security rights in equipment (see paras. 21-29), (ii) circumstances in which filing before, or concurrently with, creation is not logistically possible, or (iii) where the time difference between creation and filing cannot be minimized through the use of electronic filing or other filing techniques.

11. The ordering of priority according to the timing of filing may apply even if the creditor acquired its security right with actual knowledge of an existing unfiled security right. Qualifications based on actual knowledge require a fact-specific investigation and subject filings to challenge, creating a new issue for litigation and an incentive to attack filings. All this diminishes certainty as to priority status and thereby reduces the efficiency and effectiveness of the system. As in the case of grace periods, there is no unfairness to secured creditors in this approach because they can always protect themselves by making a timely filing.

b. Priority based on possession or control

12. As discussed in chapters III and V (see A/CN.9/WG.VI/WP.6/Add.2, paras. 5-14, and A/CN.9/WG.VI/WP.9/Add.2, paras. …), possessory security rights traditionally have been an important component of the secured lending laws of most jurisdictions. In recognition of this, even in certain jurisdictions that have a first-to-file priority rule, priority may also be established based on the date that the creditor obtained possession or control of the encumbered asset, without any requirement of a filing. In these systems, priority is often afforded to the creditor that first either filed a notice of its security right in the filing system or obtained a security right by possession or control.

13. In the case of certain types of encumbered assets, creditors often require possession or control to prevent prohibited dispositions by the grantor (i.e. instruments, such as certificated investment securities, or documents of title, such as bills of lading and warehouse receipts). For these types of assets, the priority of a security right therein may be established either by possession or control or by filing. A security right that becomes effective against third parties ("is perfected") by possession or control has priority over a security right, perfected only by filing, even if the filing occurs first. In jurisdictions that have a filing system, except in rare circumstances such as this, alternative priority systems are not permitted to coexist with the first-to-file rule.

14. In legal systems where priority may be established either by filing, possession or control, a question arises as to whether a secured creditor who initially established priority by one method should be permitted to change to another method, without losing its original priority ranking with respect to the encumbered asset. In principle, there is nothing objectionable about permitting a creditor to retain its priority, provided there is no gap in the continuity of filing, possession or control, so that the security right is subject to one method or another at all times.

c. Alternative priority rules

15. In some legal systems, priority is based on the date that the security right is created as opposed to the date of filing (a different form of first-in-time rule). This approach has been adopted in some jurisdictions that permit non-possessory security rights but have not adopted a reliable filing system, or any filing system at all. In these jurisdictions, a creditor will typically confirm the existence or non-existence of competing claims through representations by the grantor or information available in the market.

16. In other legal systems, with respect to certain types of assets such as receivables, priority is based on the time that the debtors on the receivables ("the account debtors") are notified of the existence of the security right. Like the system described in the immediately preceding and the immediately following paragraphs, this system also is not conducive to the promotion of low-cost secured credit because it does not permit the creditor to determine, with a sufficient degree of certainty at the time it extends credit, whether there are any competing security rights. However, in the case of security rights in receivables, even if notification of the account debtors is not a condition for the security right in receivables to be effective against third parties, notification may still be relevant with respect to other matters, such as discharge of the account debtor by payment to the right person or enforcement against the account debtor, even in jurisdictions that have adopted a filing system.

17. Retention of title arrangements are a primary example of security rights that are not subject to a filing requirement in most jurisdictions that recognize them and do not have a comprehensive security regime (i.e. a regime in which such rights are considered to be security rights subject to filing). In those jurisdictions, it is argued that this system is not only simple but also cost-efficient, because title retention arrangements generally are interest-free. However, the fact that such a system works in some countries does not necessarily mean that it can serve as a useful model. First, there is no single model since there are wide divergences among countries that follow this system (at least one country subjects retention of title arrangements to a filing system). Second, competition with other potential creditors is inhibited to the extent that such arrangements are available only to suppliers, as is the case in some countries. Third, even though such arrangements are often non-interest bearing, in the absence of competition credit could become more expensive, because even though not reflected in interest charges, the higher cost of credit could be built into the cost of the goods. Finally, although such systems may be extremely effective in jurisdictions that possess a mature credit economy, it is generally accepted that the establishment of a first-in-time filing system is the most effective way to introduce a credit economy in a rapid way in a country that does not have one.

3. Types of competing claimants

a. Other consensual secured creditors

18. As discussed above (see paras. 2-4), many legal systems allow the grantor to grant more than one security right in the same asset, basing the relative priority of such security rights on the priority rule (first-to-file or other rule) in effect under such system or on the agreement of the creditors (see paras. 76-77). Allowing multiple security rights in the same asset in this manner enables a grantor to use the value inherent in the asset to obtain credit from multiple sources, thereby unlocking the maximum borrowing potential of the asset.

b. Unsecured creditors

19. The grantor will often incur debts that are not secured by security rights. These general unsecured claims often comprise the bulk of the grantor's outstanding obligations.

20. While some question the fairness of giving secured creditors priority over unsecured creditors, it is well established that doing so is necessary to promote the availability of secured credit. Unsecured creditors can take steps to protect their interests, such as monitoring the status of the credit, requiring security in certain instances, charging interest on past due amounts or reducing their claims to judgements (as discussed in section A.3.e. below) in the event of non-payment. In addition, obtaining secured credit can increase the working capital of the grantor, which in many instances benefits the unsecured creditors by increasing the likelihood that the unsecured debt will be repaid. Thus, an essential element of an effective secured credit regime is that secured claims, properly obtained, have priority over general unsecured claims. Finally, in many legal systems, some classes of creditors who would otherwise be unsecured are given a special statutory priority (as discussed in section A.3.f. below).

c. Sellers of encumbered assets

i. Purchase money security rights

21. Typically, the grantor acquires its assets by purchasing them. If the purchase is made on credit provided by the seller or is financed by a lender ("purchase money financing"; see A/CN.9.WG.VI/WP.6/Add.1, paras. 16-18, and A/CN.9.WG.VI/WP.9/Add.1, paras. …) and the seller or lender obtains a security right in the goods acquired to secure the purchase money financing, consideration must be given to the priority of such rights vis-à-vis security rights in the same goods held by other parties.

22. Recognizing that purchase money financing is an effective means of providing businesses with capital necessary to acquire specific goods, many legal systems provide that holders of purchase money security rights have priority over other creditors (including creditors that have an earlier-in-time filed security right in the goods) with respect to goods acquired with the proceeds of the purchase money financing, as long as a notice of the purchase money security right is filed within an appropriate time (which may involve a "grace period" in the case of certain types of assets).

23. This heightened priority (sometimes referred to as a "super priority") is a significant exception to the first-to-file priority rule discussed in section A.2.a. above that is important in promoting the availability of purchase money financing. As illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.6/Add.1, paras. 23 and 26), businesses often grant security rights in all or some of their existing and after-acquired inventory and equipment to obtain financing. In these situations, if purchase money security rights were not afforded a heightened priority, purchase money financiers would not be able to place significant reliance on their security rights because they would rank behind existing security rights. In example 1 (see A/CN.9/WG.VI/WP.6/Add.1, paras. 18-20), vendor A, lender A and lessor A would each be reluctant to provide purchase money financing if their security rights in the goods financed ranked behind the existing security rights of lender B in example 2 and lender C in example 3.

24. Providing a heightened priority for purchase money security rights is generally not considered to be detrimental to the grantor's other creditors, because purchase money financing does not diminish the estate (i.e. the net assets or net worth) of the grantor, but instead enriches the estate with new assets in return for the purchase money obligations. For example, the security positions of lenders B and C in examples 2 and 3 are not diminished by a purchase money financing, because the lenders still have all of their encumbered assets plus a security right subordinate to the purchase money security right in the new goods financed by the purchase money credit transaction.

25. In order to promote the availability of purchase money financing without discouraging general secured credit, it is important that the heightened priority afforded to purchase money security rights only apply to the goods acquired with such purchase money and not to any other assets of the grantor.

26. In some legal systems, purchase money security rights are not subject to filing (on the theory, inter alia, that vendors of goods may be unsophisticated parties who should not be expected to file or search in the register). However, in other legal systems, purchase money security rights are subject to filing in order to avoid other creditors mistakenly relying on assets subject to purchase money security rights (see A/CN.9/WG.VI/WP.9/Add.2, paras. …).

27. From the perspective of a competing creditor, it would be beneficial if a notice of such security rights was required to be filed at the time the rights were obtained. This would mean that any creditor could search the filing system and determine with certainty, at the time of the search, whether any of the grantor's existing assets are subject to purchase money security rights. However, in order to facilitate on-the-spot financing in the equipment sales and leasing sectors, some systems provide a grace period for purchase money filings where the encumbered assets consist of equipment. To most effectively balance competing interests, this grace period must be long enough so that the filing requirement is not an undue burden to purchase money financiers, but short enough so that other secured creditors are not subject to long periods before they are able to search the registry and determine if any competing security rights exist.

28. Typically, such a grace period does not apply to filings with respect to purchase money security interests in inventory. Instead, in order to obtain a super priority in inventory, in some legal systems the holder of such a security right must,

in addition to filing, give notice of the security right to other existing holders of security rights. The argument in favour of requiring such notice is that existing inventory financiers should be put on notice of the purchase money rights so that they will not make additional loans against the debtor's existing inventory in the mistaken belief that they would have a first priority in such inventory. To otherwise eliminate this danger, they would need to check the register daily before each new advance against inventory to assure that there were no claimed purchase money rights in the inventory (a circumstance that could significantly increase the cost of such financing), and even checking daily would not suffice if a grace period were afforded to the purchase money security rights.

29. An important policy decision that must be made in fashioning a super priority for purchase money financing is whether such a priority should be available only to sellers of goods, or whether it should also extend to banks and other lenders who finance the acquisition of goods. The arguments in favour of limiting the priority to vendors tend to be historical, in that supplier-financing (e.g. in the form of retention of title arrangements) was developed as a low-cost and efficient alternative to bank financing. A principal argument in favour of extending the priority to banks and other lenders is that such equal treatment enhances competition, which in turn should have a positive impact upon both the availability and the cost of credit.

ii. Reclamation claims

30. In many legal systems, a supplier who sells goods on unsecured credit may reclaim the goods from the buyer within a specified period of time (known as the "reclamation period"). This reclamation is possible after the supplier discovers that the buyer has become the subject of an insolvency proceeding or is otherwise insolvent. Upon the return of the goods to the seller, the sales agreement under which the goods were originally sold to the buyer generally is deemed terminated.

31. Although the supplier will want the reclamation period to be as long as possible to protect its interests, other creditors will be reluctant to provide credit based on assets subject to potential reclamation claims. Moreover, if the supplier is truly concerned about the credit risk, the supplier could insist upon a purchase money security right in the goods that it supplies on credit. Accordingly, although a reclamation claim is important so that suppliers can have some rights in the goods that they supply on unsecured credit, the reclamation period should be brief (30-45 days at most) so that it does not impede lending generally.

32. An important policy consideration is whether reclamation claims relating to specific goods should have priority over pre-existing security rights in the same goods. In other words, the question is whether, if the inventory of the buyer, including the goods sought to be reclaimed, is subject to effective security rights in favour of a third party financier, the reclaimed goods should be returned to the seller free of such security rights. In some jurisdictions, the reclamation has a retroactive effect, placing the seller in the same position it was prior to the sale (i.e. holding goods that were not subject to any security rights in favour of the buyer's creditors). However, in other jurisdictions the goods remain subject to the pre-existing security rights, on the theory that any other result would be unfair to a pre-existing creditor of the buyer who had relied on the existence of such goods in extending credit, and would also promote uncertainty and thereby discourage inventory financing.

33. In many jurisdictions, reclamation claims in specific goods are extinguished at such time as the goods are incorporated into other goods in the manufacturing process or otherwise lose their identity.

d. Buyers of encumbered assets

34. The grantor may also sell assets that are subject to existing security rights. In this situation the buyer has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold. It is important that a priority rule addresses both of these interests, and that an appropriate balance be struck. If the rights of a secured creditor are jeopardized every time its grantor sells the encumbered assets, the value of such assets as security would be severely diminished, and the availability of low-cost credit based on the value of such assets would be impeded.

35. It is sometimes argued that the secured creditor is not harmed by a sale of the assets free of the security right so long as the secured party retains a security right in the proceeds of the sale. However, this would not necessarily protect the secured creditor, because proceeds often are not as valuable to the creditor as the original encumbered assets. In many instances, the proceeds may have little or no value to the creditor as security (e.g. a receivable that cannot be collected). In other instances, it might be difficult for the creditor to identify the proceeds, and its claim to the proceeds may, therefore, be illusory. Also, there is a risk that the proceeds, even if of value to the secured creditor, may be dissipated by the seller who receives them, leaving the creditor with nothing.

i. The ordinary course of business approach

36. Jurisdictions have taken a number of different approaches to achieving this balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession. One approach taken in many jurisdictions is to provide that sales of encumbered assets in the form of inventory, made by the grantor in the ordinary course of its business will result in the extinction of any security rights that the secured creditor has in the assets, automatically and without any further action on the part of the buyer, seller or secured creditor. The corollary to this rule is that sales of inventory outside the ordinary course of the grantor's business will not extinguish any security rights, and the secured creditor may, upon a default by the grantor, enforce its security right against the inventory in the hands of the buyer (unless, of course, the secured creditor has consented to the sale).

37. This approach arguably provides a simple and transparent basis for determining whether goods are sold free and clear of security rights. For example, in the case of an automobile dealership, a sale of an automobile by an automobile dealer to a consumer is clearly a sale of inventory in the ordinary course of the dealer's business, and the consumer should automatically take the car free and clear of any security rights in favour of the dealer's creditors. On the other hand, a sale by the dealer of many cars in bulk to another dealer would presumably not be in the ordinary course of the dealer's business. This approach is consistent with the commercial expectation that the grantor will sell its inventory of goods (and indeed must sell it to remain viable), and that buyers of the goods will take them free and clear of existing security rights. Without such an exemption, a grantor's ability to sell goods in the ordinary course of its business would be greatly impeded, because

buyers would have to investigate claims to the goods prior to purchasing them. This would result in significant transaction costs and would greatly impede ordinary course transactions.

38. To promote such ordinary course transfers, many legal systems provide that buyers in such transactions obtain the assets free and clear of any security right even if the buyer had actual knowledge of the security right. This exception, however, is limited in some jurisdictions if the buyer had knowledge that the sale was made in violation of an agreement between the seller and its creditor that the assets would not be sold without the consent of the creditor.

39. With respect to sales that are outside of the ordinary course of the grantor's business, as long as the creditor's security right is subject to filing in a reliable and easily accessible filing system, the buyer may protect itself by searching the filing system to determine whether the asset it is purchasing is subject to a security right, and if so, seek a release of the security right from the secured creditor. Consideration might be given to whether any low-cost items should be exempted from this rule because the search costs imposed on potential buyers may not be justified for such items. On the other hand, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in arbitrary linedrawing and would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors. As a result, it may be best not to provide for such an exemption.

40. In some countries that have a filing system that is searchable only by the grantor's name, rather than by a description of the encumbered assets, a purchaser who purchases the assets from a seller who previously purchased the assets from the grantor ("remote purchasers") obtains the assets free of the security rights granted by such grantor. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset, and accordingly, have no reason to conduct a search against the previous owner.

41. A possible disadvantage of the ordinary course of business approach is that it might not always be clear to a buyer (particularly in international trade) what activities might be within or not within the ordinary course of the seller's business. Another possible disadvantage might be that, if this rule were applied only to sales of inventory and not of other goods, there could be confusion on the part of the buyer as to whether the goods it is buying constitute inventory from the seller's point of view. On the other hand, it should be noted that, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved. In addition, this approach effectively addresses a need of practice without undermining secured credit or creating unnecessary complications. Moreover, these possible disadvantages would not apply to retail trade (where the sale is presumed to be in the ordinary course of the seller's business, and a buyer is not required to check the registry), while in other situations buyers could protect themselves by negotiating with sellers (and their secured creditors) to obtain the assets free of any security rights.

ii. The good faith approach

42. Another approach to this problem taken by some jurisdictions is to provide that a buyer of goods will take free of any security rights in the goods if the buyer purchases the goods "in good faith" (i.e. with no actual or constructive knowledge of the existence of the security rights). One argument in favour of this approach is that "good faith" is a notion known to all legal systems, and that there exists significant experience with its application both at the national and international level. It has also been argued that a presumption should exist that a buyer is acting in good faith unless it is proven otherwise.

43. A number of approaches are possible that seek to blend the "good faith" and the "ordinary course of business" approaches. One such approach is to provide that the principal criterion should be the "ordinary course of business" test, but that the "good faith" test should be applied in the situation of the "remote purchaser" described above (see para. 40). In that case, the remote purchaser would take free of security rights created by the party from whom its direct seller purchased the goods, unless the remote purchaser had actual or constructive knowledge of the security rights. Even though this approach might inadvertently open the way to abuse, since a grantor could frustrate the rights of the secured creditor by selling the goods outside the ordinary course of business to a party who would then sell them in the ordinary course of business, there is a strong policy reason to protect remote purchasers. One approach to protect secured creditors in this circumstance is to make the circumventing grantor liable to the secured creditor for damages.

e. Judgement creditors

44. In many legal systems, a security right is extended to certain classes of creditors felt to be deserving of such a right. For example, many legal systems provide that, once general unsecured creditors have reduced their claims to judgement and have taken certain action prescribed by law (such as seizing specific property or registering the judgement), such creditors are given the equivalent of a security right in that property.

45. Judgement creditors are given priority over other unsecured creditors in recognition of the legal steps they have taken to enforce their claims. This is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement. To avoid giving judgement creditors excessive powers in legal systems where a single creditor may institute insolvency proceedings, insolvency laws provide that security rights arising from judgements made within a specified period of time prior to the insolvency proceeding may be avoided by the insolvency representative.

46. Where a judgement creditor is given the equivalent of a security right, an existing creditor with an earlier-in-time consensual security right in certain assets has an interest in making sure that its security right retains its priority over the security right obtained by a judgement, particularly with respect to assets it has already relied upon in extending credit. On the other hand, the judgement creditor has an interest in receiving priority with respect to assets that have sufficient value to serve as a source of repayment of its claim.

47. Many legal systems that have a filing system rank priority in this situation by time of filing of the security right, i.e. an earlier in time filed consensual security

right in property will have priority over a subsequent security right in the same property obtained by judgement. Conversely, any attempt to grant a consensual security right in the property after a creditor has obtained some form of a judgement security right will result in an interest that is subordinate to the existing judgement security right. This approach is generally acceptable to creditors as long as the judgement security right is made sufficiently public so that creditors can become aware of it in an efficient manner and factor its existence into their credit decision before extending credit (see para. 48).

48. There is generally an exception to this rule when it is applied to future advances (discussed in greater detail in section A.4.a. below). While a previously filed security right customarily will have priority over a judgement security right with respect to credit advanced prior to the date that the judgement security right becomes effective, it will generally not have priority over the judgement security right with respect to any credit advanced after such effective date (unless such credit had been committed prior to the effective date of the judgement). For example, in example 2 (see A/CN.9/WG.VI/WP.6/Add.1, para. 23, lender B makes loans from time to time to Agrico, which are secured by all of Agrico's receivables and inventory. If an unsecured creditor reduces its claim to a judgement against Agrico and thereby obtains a security right in Agrico's inventory, lender B's security right in the inventory would have priority over the judgement security right with respect to loans that lender B made prior to the date that the judgement became effective, as well as loans that lender B made within a specified period following the effective date of the judgement. However, the judgement security right would have priority with respect to any additional loans made by lender B after the specified period (as long as lender B did not commit prior to the effective date of the judgement to extend such additional loans).

49. To protect existing secured creditors from making additional advances based on the value of assets subject to judgement security rights, there should be some mechanism to put creditors on notice of such judgement security rights. In many jurisdictions in which there is a filing system, this notice is provided by subjecting judgement security rights to the filing system. If there is no filing system or if judgement security rights are not subject to the filing system, the judgement creditor might be required to notify the existing secured creditors. In addition, it may be provided that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement security right is filed (or after the creditor receives notice) so that the creditor can take steps to protect its interest accordingly. The less time an existing secured creditor has to react to the existence of judgement security rights and the less public such judgement security rights are made, the more their potential existence will impede the availability of credit facilities that provide for future advances.

f. Statutory (preferential) creditors

50. In many jurisdictions, as a means of achieving a general societal goal (e.g. protection of tax revenue or employee wages), certain unsecured claims are given priority (in insolvency proceedings or even outside insolvency proceedings) over other unsecured claims, and in some cases, over secured claims (including secured claims previously filed). For example, to protect claims of employees and the Government, claims for unpaid wages and unpaid taxes are given, in some

jurisdictions, priority over previously existing security rights. Because societal goals differ from jurisdiction to jurisdiction, the types of these claims, and the extent to which they are afforded priority, also differ.

51. The advantage of establishing these preferential claims is that a societal goal may be furthered. The possible disadvantage is that these types of priorities can proliferate in a fashion that reduces certainty among existing and potential creditors, thereby impeding the availability of low-cost secured credit. In addition, even if the preferential claims can be ascertained with certainty by an existing or potential creditor, such claims (whether arising within or outside of insolvency proceedings) will adversely affect the availability of secured credit in another way: creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate, or by withholding the estimated amount of such claims from the available credit.

52. To avoid discouraging secured credit, the availability of which is also a societal goal, the various societal goals should be carefully weighed in deciding whether to provide a preferential claim. Preferential claims should be as limited as possible, permitted only to the extent that there is no other effective means of satisfying the underlying societal goal and the impact on the availability of low-cost credit is acceptable. For example, in some jurisdictions, tax revenue is protected through incentives on company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund.

53. If preferential claims exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims and to protect itself. Some jurisdictions have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other jurisdictions have achieved it by requiring that preferential claims be filed in a public registry, and according priority to such claims only over security rights filed thereafter. In those jurisdictions, security rights that were either filed before the preferential claims are filed, or within a specified period, such as 45-60 days, after the preferential claims are filed are given priority, if the pre-existing security rights secure a commitment to provide future advances. However, a problem with adopting a filing requirement with respect to some preferential claims that arise immediately prior to an insolvency proceeding is that it may be difficult to calculate their amount or to file in time.

g. Creditors adding value to or storing encumbered assets

54. Some legal systems provide that creditors who improve or fix encumbered assets, such as equipment repairers, have security rights in the encumbered assets they improve or fix, and that such security rights generally rank ahead of other secured claims in the encumbered assets. This priority rule has the advantage of inducing those who supply such value to continue in their efforts, and also has the advantage of facilitating the maintenance of the encumbered assets. As long as the amount that these security rights secure is limited to an amount that reflects the value by which the encumbered asset has been enhanced, such security rights and their elevated priority should be unobjectionable to existing secured creditors.

55. Some systems also provide that creditors, such as landlords and warehousemen, who store encumbered assets or who lease to a grantor the premises

on which the encumbered assets are stored, have security rights in the encumbered assets to secure the rental and storage obligations, and such security rights often rank ahead of other secured claims in the same encumbered assets.

56. In many jurisdictions, the rights described in the preceding two paragraphs are not subject to any filing requirement, and their existence can only be discerned through due diligence on the part of a prospective creditor. As a result, these security rights are often referred to as being "secret". While secret security rights have the advantage of protecting the rights of the parties to whom they are granted without requiring such parties to incur the costs associated with filing, they pose a significant impediment to secured credit because they limit the ability of creditors to determine competing security rights. As discussed in chapter V (see A/CN.9/WG.VI/WP.9/Add.2, paras. …), consideration should be given to requiring that notice of such security rights be filed in the security rights filing system.

57. If legislators give priority to the rights of such service providers, a question arises as to whether these rights should be limited in amount and recognized as priority claims subject to certain conditions. One approach may be to limit these rights in favour of service providers in amount (such as one month's rent in the case of landlords) and to recognize their priority over pre-existing security rights only where the value added directly benefits the holders of the pre-existing security rights. Another approach may be to avoid introducing such limitations since doing so would unfairly inhibit the availability of credit to such service providers. In addition, introducing such limitations may be unnecessary since secured creditors can protect themselves against such service claims in various ways, such as by contractually limiting the extent to which their grantors may enter into such service contracts, or by reserving a sufficient portion of the available credit to enable the creditor to pay the service providers in the event that the grantor fails to do so.

h. Insolvency representatives

58. It is particularly important that a secured creditor be able to determine what its priority will be in the event that an insolvency proceeding is commenced by or against its grantor, because there most likely will not be sufficient assets to pay all creditors and the encumbered assets may be its primary, or only, source of repayment. As a result, in deciding to extend credit and in evaluating priority, secured creditors generally place their greatest focus on what their priority will be in an insolvency proceeding of the grantor. Therefore, it is important that the priority of a properly obtained security right not be diminished or impaired in an insolvency proceeding. The importance of this point in crafting an effective secured transactions law cannot be over-emphasized. To the extent that secured credit and insolvency laws are not clear on this point, the willingness of creditors to provide secured credit will be seriously diminished.

59. In order to effectively compensate insolvency representatives for their work in the insolvency proceeding, they often are given a super priority preferential claim in the assets of the insolvent estate. This claim and the extent to which an insolvency representative may be empowered to challenge security rights in various circumstances are discussed in detail in chapter IX (A/CN.9/WG.VI/WP.9/Add.6, paras. …).

4. Priority in future advances and after-acquired property

a. Future advances

60. In order to determine the amount of credit to be extended and the relevant terms, a secured creditor needs to be able to determine, at the time of the conclusion of the secured transaction, how much of its claim will be accorded priority. Some legal systems limit this priority to the amount of debt existing at the time of the creation of the security right. Other legal systems require publicity of the maximum amount of credit that will be extended priority. Yet other legal systems accord priority for all extensions of credit, even those made after the creation of the security right.

61. The advantage of limiting priority to the amount of debt originally in existence at the time that the security right was created is that it may (though not necessarily) match priority with the contemplation of the parties at the time of creation, and preserves only that priority against creditors then in existence. The disadvantage of this approach is that it requires additional due diligence (e.g. searches for new filings), and additional agreements and filings for amounts subsequently advanced. This is particularly problematic because one of the most effective means of providing secured credit is on a revolving basis, since this type of credit facility most efficiently matches the grantor's particular borrowing needs (see example 2 in A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23, and Add.3, para. 9). Accordingly, future advances may be given the same priority afforded to advances made at the time that the security right is first created. In the case of credit extended in the context of contracts for the delivery of goods or services in instalments, the entire claim should be considered to have come into existence when the contract is signed, and not upon each delivery of goods or services.

62. To avoid tying up all the grantor's assets with one creditor, thus reducing the willingness with which subsequent creditors may extend credit to the grantor, many legal systems require that security right filings set forth a maximum amount of debt that may be secured by any given security right, and limit priority to such maximum amount (see A/CN.9/WG.VI/WP.9/Add.2, paras. …). It is sometimes argued that disclosing a maximum amount may raise an issue of confidentiality. However, the contrary argument is that the maximum amount in the filed notice does not necessarily reflect the actual amount of the secured obligation, but only the maximum amount that may be recovered in the event the security right is enforced.

b. After-acquired property

63. As discussed in greater detail in chapter IV (see A/CN.9/WG.VI/WP.6/Add.3, paras. 19-23), in some legal systems a security right may be created in property that the grantor may acquire in the future. Such a security right is obtained simultaneously with the grantor's acquisition of the property, without any additional steps being required each time additional property is acquired. As a result, the costs incident to the grant of a security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory (which is acquired for resale), receivables (which are collected and regenerated on a continual basis) (see example 2 in A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23) and equipment (which is replaced in the normal course of the grantor's business).

64. The allowance of security rights in after-acquired property raises the question of whether the priority dates from the time of the initial grant or from the time the grantor acquires the property. Different legal systems address this matter in different ways. Some legal systems vary the effect depending on the status of the creditor competing for priority (with priority dating from the date of the grant vis-à-vis other consensual security creditors, and from the date of acquisition vis-à-vis all other creditors). It is generally accepted that dating priority from the initial grant, rather than from the date the grantor acquires rights in the encumbered assets, is the most efficient and effective approach in terms of promoting the availability of low-cost secured credit (see, for example, article 8 (2) of the United Nations Assignment Convention).

5. Priority in proceeds

65. If the creditor has a right in proceeds and civil fruits of the original encumbered asset, issues will arise as to the status and priority of that right as against other competing claimants. Competing claimants with respect to proceeds may include a creditor of the grantor who has obtained a right by judgement or execution against the proceeds and another creditor who has a security right in the proceeds as original encumbered assets, as well as other competing claimants of the types mentioned above (as to what constitutes proceeds, see A/CN.9/WG.VI/WP.6/Add.3, paras. 36-40).

66. A secured creditor may have a security right in proceeds as original encumbered assets or as after-acquired proceeds of other encumbered assets. For example, assume that creditor A has a security right in all of the grantor's inventory and creditor B has a security right in all of the grantor's receivables (including future receivables). Assume further that the grantor debtor later sells on credit inventory that is subject to the security interest of creditor A. Both creditors have a security right in the receivable generated by the sale. Creditor B has a right in the receivable as an original encumbered asset and creditor A has a security right in the receivable as proceeds of the encumbered inventory.

67. A comprehensive legal system governing security rights must answer several questions with respect to competing claims of the above-mentioned secured creditors. One question is whether the right of creditor A in the receivable as proceeds of inventory is effective not only against the grantor but also against competing claimants. The answer to this question must be affirmative, in most circumstances. Otherwise, the value of the original encumbered assets (e.g. the inventory) would be largely illusory. Security rights add economic security (thereby increasing access to credit at lower cost) only in cases in which the security right provides the creditor with the right to apply the economic value of the encumbered asset to the debt owed to the creditor before that value is applied to claims of other claimants.

68. Nonetheless, it must be recognized that the creation of a right in proceeds raises important concerns about the risks created for third parties. In particular, considerations that lead to a requirement of publicity for a security right in particular property to be effective against third parties may suggest that similar requirements are appropriate for the right in proceeds.

69. Therefore, a legal regime should contain rules that determine when the publicity that is given to the security right in the original encumbered asset will suffice to publicize the creditor's right in the proceeds. In cases in which a different mode of publicity (e.g. notification of an account debtor instead of filing) is required for the creditor's right in the proceeds, the legal regime should provide a period of time after the transaction generating the proceeds in which the creditor may provide the publicity without losing its right in the proceeds.

70. While determination of whether a new act of publicity is necessary in order for the creditor's right in proceeds to be effective against third parties is quite important, that determination alone is not sufficient to resolve the relative rights of the secured creditor and other creditors in proceeds. In particular, priority rules are needed to determine the relative priority of the secured creditor's right.

71. The priority rules may differ depending on the nature of the competing claimant. For example, if the competing claimant is another secured creditor whose rights are also dependent on publicity, the rules determining the relative priority of the rights of the two secured creditors might depend on the nature and timing of the publicity. Priority may depend on other factors when the competing claimant is a judgement creditor or an insolvency administrator.

72. In many cases in which the competing claimant is another secured party, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to the original encumbered asset and the policies that generated those rules. For example, in a legal system in which the first right in particular property that is publicized has priority over competing rights, that same rule could be used to determine the priority when the original encumbered asset has been transferred and the secured creditor now claims a right in proceeds. If the right in the original encumbered asset was publicized before the right of the competing claimant in the proceeds was publicized, that right could be given priority.

73. In cases in which the order of priority of competing rights in the original encumbered asset is not determined by the order of publicity (as is the case, for example, with purchase money security rights that enjoy a super priority) a separate determination will be necessary for the priority rule that would apply to the proceeds of the original encumbered asset.

6. Voluntary alteration of priority: subordination agreements

74. In many legal systems, priority may be, and frequently is, altered by a secured creditor unilaterally or by private contract with other secured creditors. As an example, a lender with a security right in all existing and after-acquired assets of a grantor could agree that the grantor might give a first priority security right in a particular asset so that the grantor could obtain additional financing from a source other than the lender based on the value of that asset. Such agreements are to be distinguished from subordination agreements between unsecured creditors waiving the principle of equal treatment of their unsecured claims. The recognition of the validity of subordination of security rights unilaterally or by private contract reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention).

75. Such agreements altering priority are perfectly acceptable as long as they affect only the parties who actually consent to such alterations. Subordination

agreements should not affect the rights of creditors who are not parties to the agreement. Additionally, it is essential that the priority afforded by a subordination agreement continue to apply in an insolvency proceeding of the grantor, and the insolvency laws should so provide. In fact, in some jurisdictions, such a provision in the insolvency laws may be necessary to empower the courts to enforce subordination agreements, and to empower insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see A/CN.9/WG.VI/WP.9/Add.6, paras. …).

7. Relevance of priority prior to enforcement

76. Another important issue pertaining to priority is whether priority only has relevance after the occurrence of a default by the grantor in the underlying obligation or whether priority also has relevance prior to default. Many jurisdictions adopt the former approach, thereby allowing the holder of a subordinate consensual security right to receive a regularly scheduled payment on its obligation even though the secured obligation having priority has not been paid in full, absent a contrary agreement between the first-ranking and subordinate claimants. The theory for this approach is that, absent a contrary agreement and prior to a default, a grantor should be free to dispose of its assets and use the proceeds to pay its obligations as they mature, irrespective of the relative priority of the security rights in such assets. Requiring the subordinate claimant to remit the payment absent such an express agreement would be a major impediment to the subordinate claimant providing financing.

77. The result may be different if the subordinate claimant received proceeds from the collection, sale or other disposition of the encumbered asset. In that circumstance, some jurisdictions require the subordinate claimant to remit the proceeds to the first-ranking claimant if the subordinate claimant received the proceeds with the knowledge that the grantor was required to remit them to the first-ranking claimant. The rationale behind this rule is similar to the rationale discussed in section A.3.d. above with respect to buyers of encumbered assets.

B. Summary and recommendations

78. The concept of priority is a critical component in any secured transactions regime that seeks to promote the availability of low-cost secured credit. The availability of credit is dependent on the ability of creditors to determine, with a high degree of certainty prior to extending credit, what their priority will be if they attempted to realize on their security. Because such realization often occurs in an insolvency proceeding of the grantor, it is critical that a secured creditor's priority continue unimpaired in the insolvency proceeding (see A/CN.9/WG.VI/WP.9/Add.6, para. …).

79. It is, therefore, important that secured transactions laws include priority rules that are clear and workable leading to predictable outcomes. These rules should allow all creditors, even unsecured creditors, to assess their positions in advance of extending credit and to take steps to protect their interests. Clear priority rules that result in predictable outcomes and efficient mechanisms for ascertaining and

establishing priority at the time credit is advanced are as important to creditors as the particulars of the priority rule itself.

80. This result may be achieved most effectively by establishing a filing system and according priority to the first to file a notice of a security right. In addition, assuming that the filing system is reliable and easily accessible, it may provide an effective mechanism for alerting creditors to competing security rights (see paras. 7-9).

81. An essential element of an effective secured transactions regime is that secured claims, properly obtained, should have priority over general unsecured claims.

82. If possessory security rights are to remain a component of a security regime, they must be taken into account in crafting a priority rule. Thus, it may be appropriate to provide that the priority of a security right may be established either by possession or control or by filing, whichever occurs first. In such situations, it is also appropriate to permit a secured creditor who initially established priority by one method to change to another method, without losing its original priority ranking with respect to the encumbered asset, provided there is no gap in the continuity of filing, possession or control, so that the security right is subject to one method or another at all times. Moreover, in the case of certain types of assets, it may be appropriate to provide that a security right perfected by possession or control has priority over a security right that is perfected only by filing, even if the filing occurs first (see paras. 12-14).

83. Exceptions to the first-to-file priority rule should only be considered to the extent that there is no other means to satisfy the underlying policy objective of the exception and that objective justifies the impact of the exception on the availability of low-cost credit. Any such exceptions should be stated clearly, allowing creditors to assess the likelihood of any preferential claims and to take steps to protect themselves with respect to such claims. In order to most effectively alert creditors as to competing claims, consideration should be given to subjecting all claims, including preferential claims, to the security right filing system (see paras. 50-53). Some important exceptions to the first-to-file priority rule that should be addressed in crafting secured transactions laws pertain to purchase money security rights, and creditors that add value to encumbered assets (such as equipment repairers; see paras. 54-57).

84. Because purchase money financing is an effective means of providing businesses with capital necessary to acquire specific goods, an effective secured transaction regime should provide that holders of purchase money security rights have priority over other creditors (including creditors that have an earlier-in-time filed security right in the goods) with respect to goods acquired with the proceeds of the purchase money financing. With respect to transactions relating to inventory, in addition to filing, appropriate notice of the purchase money security right should be given to other creditors on record. In addition to vendors of goods, this heightened priority should be extended to banks and other lenders who finance the acquisition of goods (see paras. 21-29).

85. An effective secured transaction regime should strike an appropriate balance between the rights of buyers of goods and secured creditors holding security rights in such goods. Such a balance should include a provision that buyers of inventory

sold in the ordinary course of the grantor's business should take free of any security rights in the goods granted by the seller, and the secured creditor should receive a security right in the proceeds of sale (see paras. 34-43).

86. Recognizing priority with respect to future advances and after-acquired property is likely to encourage the availability of revolving and other similar credits to businesses. The simpler the procedure that a creditor must comply with in order to establish priority with respect to future advances and after-acquired property, the greater will be the availability of these forms of credit (see paras. 60-63).

87. To avoid hindering the advancement of revolving credits as discussed above (see paras. 47 and 60) or any other similar form of credit, the amount to which future advances are afforded priority should not be limited.

88. At least in certain circumstances, the right of the secured creditor in the proceeds of its encumbered assets should be effective not only as against the grantor but also as against competing claimants. A legal regime should provide when a publicity act with respect to the security right suffices to publicize the creditor's rights in the proceeds or when a new publicity act is required. In addition, a legal regime should include priority rules with respect to rights in proceeds. Such rules may differ depending on the nature of the competing claimant (see paras. 65-73).

89. Regardless of the priority rules of any secured transactions regime, creditors should be permitted to vary such rules by private contract in order to structure financing arrangements that best suit the grantor's needs. Such agreements should be recognized as effective among the parties thereto in the grantor's insolvency proceeding. However, they should not affect the rights of persons who are not parties to such agreements (see paras. 74-75).

90. Finally, secured transactions regimes should specify the circumstances in which the holders of subordinate security rights in specific encumbered assets will, prior to default and enforcement, be prevented from taking actions that are inconsistent with the rights of the holders of first-ranking security rights in the same assets. Examples of such actions include retaining proceeds from the sale or other disposition of such assets with knowledge of the grantor's contractual obligation to remit those proceeds to the first-ranking secured creditor (see paras. 76-77).