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Report of Working Group VI (Security Interests) on the work of its second session (Vienna, 17-20 December 2002)

Contents

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I. Introduction

1. At its present session, the Working Group continued its work on the development of "an efficient legal regime for security rights in goods involved in a commercial activity".[1]

2. The Commission's decision to undertake work in the area of secured credit law was taken in response to the need for an efficient legal regime that would remove legal obstacles to secured credit and could thus have a beneficial impact on the availability and the cost of credit.[2]

3. At its thirty-third session (2000), the Commission discussed a report prepared by the Secretariat on issues to be addressed in the area of secured credit law (A/CN.9/475). At that session, the Commission agreed that secured credit law was an important subject and had been brought to the attention of the Commission at the right time, in particular in view of its close link with the work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck, however, in that regard to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States. Furthermore, it was stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable.[3]

4. At its thirty-fourth session (2001), the Commission considered another report prepared by the Secretariat (A/CN.9/496) and agreed that work should be undertaken in view of the beneficial economic impact of a modern secured credit law. It was stated that experience had shown that deficiencies in that area could have major negative effects on a country's economic and financial system. It was also stated that an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate restructuring by providing a vehicle that would create incentives for interim financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.[4] As to the form of work, the Commission considered that a model law would be too rigid and noted the suggestions made for a set of principles with a legislative guide that would include legislative recommendations.[5]

5. At its first session (New York, 20-24 May 2002), the Working Group considered chapters I to V and X (A/CN.9/WG.VI/WP.2 and Add.1-5 and 10) of the first preliminary draft guide on secured transactions, prepared by the Secretariat. At

that session, the Working Group requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/512, para. 12). At that session, the Working Group also considered suggestions for the presentation of modern registration systems in order to provide the Working Group with information necessary to address concerns expressed with respect to registration of security rights in movable property (see A/CN.9/512, para. 65). At the same session, the Working Group agreed on the need for coordination with Working Group V (Insolvency Law) on matters of common interest and endorsed the conclusions of Working Group V with respect to those matters (see A/CN.9/512, para. 88).

6. At its thirty-fifth session (2002), the Commission considered the report of the first session of the Working Group (A/CN.9/512). It was widely felt that the legislative guide was a great opportunity for the Commission to assist States in adopting modern secured transactions legislation, which was generally thought to be a necessary, albeit not sufficient in itself, condition for increasing access to low-cost credit, thus facilitating the cross-border movement of goods and services, economic development and ultimately friendly relations among nations. In that connection, the Commission noted with satisfaction that the project had attracted the attention of international, governmental and non-governmental organizations and that some of those took an active part in the deliberations of the Working Group.

7. At that session, the Commission also felt that the timing of the Commission's initiative was most opportune both in view of the relevant legislative initiatives under way at the national and the international level and in view of the Commission's own initiative in the field of insolvency law.

8. After discussion, the Commission confirmed the mandate given to the Working Group at its thirty-fourth session to develop an efficient legal regime for security rights in goods, including inventory. The Commission also confirmed that the mandate of the Working Group should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.[6]

II. Organization of the session

9. The Working Group, which was composed of all States members of the Commission, held its second session in Vienna from 17 to 20 December 2002. The session was attended by representatives of the following States members of the Commission: Argentina (alternating annually with Uruguay), Austria, Brazil, Cameroon, Canada, China, Colombia, France, Germany, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Lithuania, Mexico, Morocco, Romania, Russian Federation, Rwanda, Singapore, Spain, Sudan, Sweden, Thailand, The Former Yugoslav Republic of Macedonia, United Kingdom of Great Britain and Northern Ireland and United States of America.

10. The session was attended by observers from the following States: Algeria, Australia, Belarus, Bulgaria, Indonesia, Kuwait, Lebanon, New Zealand, Philippines, Poland, Republic of Korea, Senegal, Slovakia, Switzerland, Syrian Arab Republic, Turkey, Ukraine, Venezuela and Yemen.

11. The session was also attended by observers from the following national or international organizations: (a) organizations of the United Nations system:

International Monetary Fund (IMF), the World Bank; (b) intergovernmental organizations: Asian-African Legal Consultative Organization (AALCO), Common Market for Eastern and Southern Africa (COMESA), International Institute for the Unification of Private Law (UNIDROIT); (c) non-governmental organizations invited by the Commission: American Bar Association (ABA), American Bar Foundation (ABF), Center for International Legal Studies, Center of Legal Competence (CLC), Commercial Finance Association (CFA), Europafactoring, International Bar Association, Committee J (IBA), International Federation of Insolvency Professionals (INSOL), International Chamber of Commerce (ICC), Max-Planck-Institute, Society of European Contract Law (SECOLA), The Association of the Bar of the City of New York and Union of Industrial and Employers' Confederations of Europe (UNICE).

12. The Working Group elected the following officers:

Chairman: Ms. Kathryn SABO (Canada)

Rapporteur: Mr. Vilius BERNATONIS (Lithuania)

13. The Working Group had before it the following documents: A/CN.9/WG.VI/WP.5 (provisional agenda), A/CN.9/WG.VI/WP.2 and Add.6-9, 11 and 12, as well as A/CN.9/WG.VI/WP.6 and Add.1-5 (draft legislative guide on secured transactions).

14. The Working Group adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Preparation of a legislative guide on secured transactions.
4. Other business.
5. Adoption of the report.

III. Deliberations and decisions

15. The Working Group considered chapters VI, VII and IX of the draft Guide. The deliberations and decisions of the Working Group are set forth below in part IV. The Secretariat was requested to prepare, on the basis of those deliberations and decisions, a revised version of chapters VI, VII and IX of the draft Guide.

IV. Preparation of a legislative guide on secured transactions

Chapter VI. Filing

General remarks

16. It was noted that the term "filing", as opposed to the term "registration", was used in order to emphasize the difference between the system envisaged in the draft Guide and traditional registries. It was stated that, unlike traditional registration, filing involved only a notice, rather than the transaction documents, and provided a warning to potential financiers about the possible existence of a security right and a

system to settle priority conflicts, rather than constituting the right. In order to reflect these characteristics of filing, it was suggested that reference should be made to a "filed notice" rather than to a "filed security right".

17. It was also observed that filing raised the same concerns expressed with respect to chapter V (see A/CN.9/512, paras. 63-67), in particular concerns about cost and complexity. In response, it was observed that the overall cost was probably higher in the absence of publicity.

A. Introduction

18. A number of suggestions were made. One suggestion was that the purpose of filing should be further clarified in the introductory paragraphs. Another suggestion was that, in paragraph 3, reference should be made to priority as against an insolvency representative. Yet another suggestion was that, in paragraph 4, it should be clarified that filing ensured enforceability of a security right against third parties. Yet another suggestion was that another system in which documents were presented to the filing office, checked and filed in summary form, should also be discussed.

B. Notice filing vs. document filing

19. With respect to paragraph 7, in response to a question, it was stated that the amount of the secured obligation should not be part of the information to be filed. As to whether a maximum amount secured should be specified in the notice, the Working Group noted that the matter raised a policy issue that was adequately discussed in paragraphs 11 and 12, as well as in chapter V (see paras. 35-37). The concern was expressed that a requirement to specify in the notice a maximum amount would raise issues of confidentiality. In response, it was observed that the maximum amount in the notice did not refer to the amount of the secured obligation but to the maximum amount that could be recovered in the case of enforcement of a security right. With respect to paragraph 14, it was suggested that, as the issue of filing with respect to foreign debtors or grantors raised conflict-of-laws issues, a cross-reference to the conflict-of-laws chapter should be made.

C. Authority to file and signature

20. Support was expressed for the approach taken in paragraphs 15 to 17, according to which the debtor's signature did not have to be on the notice filed. It was stated that such a requirement would slow down the filing process and it was unnecessary since creditors would gain nothing from unauthorized filing and debtors could obtain relief.

D. Grantor- or asset-based index

21. It was noted that paragraphs 18 to 21 adequately discussed the issue whether the index should be organized on the basis of the debtor's or other grantor's name or on the basis of asset identification.

E. The filing process

22. Support was expressed for a fully computerized filing system. It was stated that such a system was significantly more transparent and cost-effective than a paper-based system.

F. Duration of effectiveness of a filed notice

23. It was stated that, in some legal systems, there was a time period after creation of a security right within which notice of it should be filed ("grace period"). It was observed that such a time period was intended to prevent fraud in particular in the case of insolvency. While it was agreed that the matter could be discussed in the draft Guide, it was widely felt that such a time period was not necessary since the need to ensure priority was a sufficient incentive for secured parties to file. It was also stated that imposing an arbitrary time period was not appropriate with the exception of security rights with respect to which priority dated back to the time of creation rather than to the time of filing (e.g. purchase money security rights). In addition, it was observed that it was important to distinguish between a time period as a condition to achieving super priority and a time period that might relate to the general effectiveness of the filing.

G. Public access and extent of detail in statutory text

24. It was noted that paragraphs 34 to 36 were adequate in discussing public access to the database and the extent of detail in the law.

H. Fees

25. It was agreed that filing fees should be kept to a minimum and be based on cost-recovery rather than on percentages of the value of the secured claim. It was also widely felt that filing should not be used for purposes unrelated to its warning and priority functions (e.g. for collecting stamp duties).

I. Other elements of a filing system

26. It was stated that a filing system operated by a private entity might have the advantage that any cost would not have to be borne by the Government but by the businesses using the services of the filing office. It was also observed that rights in certain high-value and uniquely identifiable movables, such as vessels and aircraft, might be more appropriately filed in alternative registration systems.

J. Summary and recommendations

27. It was agreed that a recommendation should be added with respect to the need for the filing fee to be nominal. It was also widely felt that, as the draft Guide was intended to serve as a basis for preparing national legislation, the focus should be on national registries. It was stated, however, that, to the extent that national legislation followed the recommendations in the draft Guide, national registries could be linked and facilitate trade across national borders. In that connection, it was observed that international registration systems, such as the ones envisaged in the United Nations Convention on the Assignment of Receivables in International Trade and the Convention on International Interests on Mobile Equipment and the relevant Protocols, could provide useful examples. With regard to the latter, it was noted that it envisaged an international asset-based and fully computerized registry.

28. After discussion, the Working Group requested the Secretariat to revise chapter VI taking into account the views expressed and the suggestions made.

Chapter VII. Priority

A. The concept of priority and its importance

29. A number of suggestions were made. One suggestion was that, in paragraph 2, the statement linking priority to the availability of credit should be qualified since that result depended on the type of the security right. Another suggestion was that, in paragraph 4, it should be made clearer that, while the focus of the draft Guide should be on consensual security rights, conflicts of priority with non-consensual security rights should also be discussed. Yet another suggestion was that, in paragraph 4, clarity of law should be emphasized without under-estimating the importance of workable rules, since not all clear rules were equal.

B. First-to-file priority rule

30. It was suggested that that section could be prefaced with a statement to the effect that the various priority rules it referred to could coexist in the same legal system applying to different types of conflict. With respect to paragraph 6, the concern was expressed that it failed to reflect a minority view, according to which priority based on filing was not the most appropriate rule. In response, it was stated that the draft Guide would be more useful to the extent it contained clear recommendations and that, if alternative rules were presented, their relative disadvantages would also have to be discussed.

31. With respect to paragraph 9, the Working Group considered the question whether, if creation of a security right and filing of a notice of it did not coincide, the secured creditor should be given a grace period within which to file, with priority dating back to the time of creation. While some support was expressed for a flexible regime with grace periods, the prevailing view was against such broad exceptions to the first-to-file priority rule. It was stated that, in order to avoid undermining the certainty achieved by a first-to-file rule, exceptions in the form of grace periods should be prescribed in a very narrow and clear way. Such exceptions could apply only to specific situations (e.g. to purchase money security rights) or only if filing was not possible before creation or the time difference between creation and filing could not be significantly reduced through the use of the appropriate filing technique (e.g. electronic filing). It was agreed that paragraph 9 should be revised to reflect that understanding.

32. As to paragraph 12, the concern was expressed that it gave the impression that possession and filing could generally coexist and that by obtaining possession a creditor could obtain priority over a security right, notice of which was previously filed. It was stated that, in jurisdictions with a filing system, to the extent possible, alternative priority rules should not coexist with the first-to-file rule. It was also observed that: the first-to-take possession or control rule should apply with respect to security rights in assets susceptible to possession only; and the first-to-file rule should apply with respect to security rights in assets insusceptible to possession or assets with respect to which possession was not practical. It was also suggested that, in the case of security rights in assets susceptible to both possession and filing, priority should be accorded to the first to obtain possession or to file. It was noted that that approach was followed in the Inter-American Model Law on Secured Transactions (articles 10 and 52). There was broad support for that suggestion. It

was also widely felt that exceptions to that rule should be very limited and apply, for example, to documents of title, such as bills of lading and warehouse receipts.

C. Alternative priority rules

33. With respect to paragraph 14, the concern was expressed that it was not sufficiently balanced to the extent that it suggested that a priority rule based on the time of creation of a security right was a major impediment to the availability of low-cost credit. It was stated that, while no system might be perfect, that system worked, at least in some countries, as well as any other system. It was also observed that such a system was simple and cost-efficient. In addition, it was stated that, in such a system, parties were aware of the existence of retention-of-title arrangements through debtor representations or information otherwise available in the market, and priced their transactions accordingly. In support of supplier credit with retention-of-title arrangements in particular, it was said that, in some countries with a first-in-time of creation rule, it generated much more credit and at much lower cost than bank credit (e.g. because no interest was charged).

34. In response, it was observed that the fact that such a system seemed to work in some countries did not mean that it provided a good model for most countries. In particular with respect to retention-of-title arrangements, it was said that practice varied from country to country and there was no single model. It was noted that, in some countries, such arrangements were only available to certain suppliers and only in the case of transaction with individual debtors, while, in at least one other country, retention-of-title arrangements were subject to public registration. It was also stated that competition would normally be inhibited in situations where suppliers, who, as was generally admitted, deserved to be protected, would be overly protected through priority without any publicity at the expense of other credit providers. In the absence of competition ensured by equal access to credit-relevant information, credit would be more expensive even if the cost was not reflected in the interest but in the price of the relevant goods. After discussion, it was agreed that paragraph 14 should be redrafted to add balance to the discussion, taking into account the views expressed and the suggestions made.

35. As to paragraph 15, it was agreed that it should be made clear that, even if notification of the debtor of the receivable was not a condition for a transaction involving receivables to be effective against third parties, notification was still relevant with respect to claims or enforcement as against the debtor of the receivable.

D. Other consensual secured and unsecured creditors

36. It was suggested that, in paragraph 18, adjustment of interest rates should be added to the list of steps unsecured creditors could take to protect themselves. It was also suggested that reference should be made to conflicts of priority between holders of security rights in fixtures and holders of security rights in the movable or immovable property to which the fixtures were attached.

E. Sellers of encumbered assets with purchase money security rights

37. With respect to paragraph 19, the question was raised as to whether supplier credit and bank credit for the purchase of goods could be assimilated into the same

category of "purchase money security rights" and treated in the same way. It was stated that supplier credit, supported through retention-of-title arrangements, was developed as an alternative to bank credit that was secured with security in all the assets of a debtor. It was also observed that, in many legal systems, supplier credit was given priority over bank credit for general socio-economic reasons and that, therefore, treating bank credit in the same way as supplier credit was an important policy decision, the advantages and disadvantages of which needed to be weighed carefully. In response, it was stated that, in the interest of promoting trade, suppliers and banks providing purchase money credit should be treated in the same way. It was observed that such an equal treatment would enhance competition, which in turn should have a positive impact on the availability and the cost of credit.

38. While some doubt was expressed, there was broad support in the Working Group for the principle, reflected in paragraphs 20 and 21, that purchase money credit (however defined) should be given heightened priority as of the time of the creation of the security right ("super-priority"), as long as it was filed within a prescribed time period after creation. The main justification mentioned for that approach was that super priority was not detrimental to other creditors as long as purchase money credit enriched the debtor's estate with new assets. However, in view of the possibility that that might not be the case with inventory, the purchase of which could be financed by inventory financiers, differing views were expressed as to whether holders of purchase money security rights should, in addition to filing, give notice to inventory financiers in order to ensure super-priority. One view was that such notice was necessary so as to inform inventory financiers not to extend more credit with the exception of cases in which there was excess value beyond the value of the rights of the purchase money financier. It was stated that, in the absence of such a notice, inventory financiers would need to check the register daily before they advance new credit against new inventory, a result that would complicate inventory financing. Another view was that such a notice to inventory financiers was unnecessary. It was stated that, once holders of purchase money security rights had filed a notice, the compliance cost should be on third parties expected to search in the register. In the discussion, the view was also expressed that filing might not be required at all or, at least, in some cases since suppliers included unsophisticated parties that should not be expected to file or to search in the register (for certain exceptions to filing, see A/CN.9/WG.VI/WP.2/Add.5, para. 67). After discussion, it was agreed that these different views should be reflected in the draft Guide.

F. Sellers of encumbered assets with reclamation claims

39. It was noted that the main question in paragraph 25 was whether a seller, reclaiming, under contract law, property in assets sold within a short period prior to the buyer's insolvency, had priority over or took the assets free of any security right granted by the buyer. It was also noted that, in situations where the seller had retained title, the issue was whether the seller should be given super-priority even if it had not filed a notice.

40. While some doubt was initially expressed as to whether that was a matter of secured transaction law, the Working Group agreed that it should be discussed in the draft Guide. As to the way in which it should be addressed, differing views were expressed. One view was that revendication by the seller had retroactive effects and, therefore, the seller should obtain the goods free of any security right. The

prevailing view, however, was that the seller should obtain the goods subject to the security rights, at least in the case of a security right in the specific assets sold. It was stated that, even if the retransfer of property to the seller had retroactive effects, the secured party relying on the appearance of ownership on the part of the buyer should be protected. In the discussion, a number of suggestions were made. One suggestion was that the matter arose not only in the case of the debtor's insolvency but also in the case of debtor default. Another suggestion was that reference should be made to avoidance of the relevant sales agreement. After discussion, it was agreed that these views and suggestions should be reflected in the draft Guide.

G. Buyers of encumbered assets

41. There was general support for the need to strike an appropriate balance between the interests of buyers of encumbered assets and creditors with security rights in those assets. However, differing views were expressed as to the ways in which that policy could be implemented. One view was that the basic criterion for establishing a balance between the interests of buyers and the interests of secured creditors was the notion of "ordinary course of business". It was stated that that notion, which referred to the line of business the debtor was involved in, was a simple and transparent notion. The example was mentioned of a sale of cars by a car dealer.

42. Another view was that the basic criterion should be the principle of "good faith". It was observed that "good faith" was a notion known to all systems and there was significant experience with its application both at the national and the international level. The example was given of a buyer with no actual knowledge of the existence of a security right. In addition, it was stated that all buyers should be presumed to be in good faith unless otherwise proven. Yet another view was that the main criterion should be the notion of "ordinary course of business" but that the principle of good faith could apply to exceptional situations, such as where A bought goods from B who had bought them from the debtor or other grantor (A would be a "remote purchaser"). It was said that that would be necessary since if A were to search the registry by the name of B it would not find out about the security right granted by the debtor or other grantor.

43. Various concerns were expressed with respect to both notions of "ordinary course of business" and "good faith". It was stated that these notions were not clear and that their use could create uncertainty, in particular in international trade. In particular, with respect to the notion of "ordinary course of business", it was observed that it might not be apparent to the buyer what the ordinary course of business of the debtor selling the encumbered assets might be. In addition, it was stated that applying the notion of "ordinary course of business" only to inventory would create an additional complication since it might not be clear to the buyer that the asset was inventory from the seller's point of view. Moreover, it was said that, in jurisdictions with filing systems, the mere existence of filing created the presumption that all buyers were in bad faith.

44. In response, it was said that, in a normal buyer-seller relationship, buyers would know what type of business the seller was involved in. In addition, it was observed that limiting the protection of the buyer to the case where inventory was sold in the ordinary course of business addressed a need of practice without undermining secured credit or creating unnecessary complication. Moreover, it was

emphasized that, as that rule did not apply to retail trade, buyers were not required to check the registry and were presumed to be in good faith. In other situations, buyers could protect their interests by negotiating with sellers and their secured creditors to obtain the assets free of any security right.

45. In order to bridge the gap between these diverging views, a number of suggestions were made. One suggestion was that emphasis should be placed on the common interest not to disrupt retail trade and not on the legal theories developed to achieve that result. Another suggestion was that, if a filing system were adopted, the matter could be addressed by creating a presumption that buyers that did not have to search in the registry were in good faith and that the encumbered assets sold were part of the debtor's inventory.

46. With respect to the view that remote purchasers should be protected (either on the basis of the notion of "ordinary course of business" or a combination of that notion with the principle of good faith), it was stated that it might inadvertently open the way to abuse, since a debtor could frustrate the rights of the secured creditor by selling an encumbered asset outside the ordinary course of its business to a party that would then sell it in the ordinary course of its business. On the other hand, support was expressed for the need to protect remote purchasers. It was stated that secured creditors could be protected by making the debtor liable to damages towards the secured creditor.

H. Judgement creditors

47. The view was expressed that judgement creditors should be treated in the same way as other unsecured creditors. In support, it was stated that, otherwise, a creditor could inappropriately obtain priority by having its claim recognized in a court judgement. That result was said to be particularly unfair in jurisdictions where even a single creditor could apply to have the debtor declared insolvent. In response, it was stated that, in jurisdictions in which judgement creditors were granted priority by statute, such priority was not applicable in the case of insolvency. With respect to paragraph 36, it was observed that consideration should be given to giving priority to judgement creditors over secured creditors with respect to advances made within a prescribed time period after the issuance of a judgement.

I. Statutory (preferential) creditors

48. It was stated that statutory preferential claims (e.g. for wages or taxes), whether within or outside insolvency, increased the risk that secured creditors might not be paid in full. To the extent that that risk was manageable, it was observed, secured creditors would evaluate it and turn it over to the debtor, for example, by increasing interest rates or by withholding part of the credit. In order to avoid that result, it was generally agreed, statutory preferential claims should be as limited as possible, imposed only to the extent that there was no other means of implementing the relevant social policies and prescribed in a clear and transparent way.

49. It was stated that, as a practical matter, secured creditors should not have to bear an undue share in subsidizing the Government's social policy. It was also observed that there was a variety of means to finance such policies (e.g. employee insurance funds). With respect to transparency, it was said that it could be served, for example, by listing preferential claims in one law or in an annex to the law, or

by requiring that they be filed in a public registry. In that connection, it was observed that, in some jurisdictions, certain preferential claims were subject to filing. In at least one jurisdiction, it was said, the Government had to file its claims and those claims obtained priority only forty-five days after filing. On the other hand, it was said that other preferential claims arose only immediately before insolvency (e.g. claims for wages) and it was difficult to file them in time or to calculate their amount. It was also stated that relying on insurance funds might not provide a solution since such funds often substituted employees and claimed payment as preferential creditors. After discussion, it was agreed that a strong recommendation should be made in the draft Guide with respect to preferential claims along the lines mentioned above (paragraph 48).

J. Creditors adding value to or storing encumbered assets

50. There was support for the view that the extent, scope and nature of the right of creditors adding value to or storing assets, as well as filing requirements and priority should be further discussed in the draft Guide. With regard to the extent of the right, it was stated that the right should be limited in amount (e.g. in the case of landlords, to one month's rent) and be recognized only where the value added benefited the secured creditor. On the other hand, it was said that such an approach might limit credit availability to such service providers. It was also observed that secured creditors could protect themselves in various ways, including by imposing conditions with respect to service contracts relating to the encumbered assets. As to the scope of the right, it was stated that creditors creating or preserving value needed to be treated in the same way as creditors adding value to or storing the encumbered assets. Reference could also be made to other creditors with retention of possession rights, which operated like possessory pledges (see A/CN.9/WG.VI/WP.6/Add.2, para. 14).

51. With regard to the nature of the right and filing requirements, it was suggested that a distinction be made between a right of retention and a non-consensual security right. It was observed that the right of retention existed as long as the debtor had possession and that in that case no filing was necessary. That right was said to be more a means of exerting pressure on the debtor to pay rather than a priority right. It was also said that, once the debtor had lost possession, the creditor could only rely on the non-consensual security right and in that case filing would be useful to warn other creditors and to provide a method of resolving priority disputes. In the discussion, a note of caution was struck that expanding the scope of the exceptions to the normal priority rules could undermine their effectiveness.

K. Insolvency administrators

52. It was agreed that the issue in paragraph 44 should be briefly stated and a cross-reference should be made to the detailed discussion in the chapter dealing with security rights in the case of insolvency. It was suggested that it should be made clear that the preferential claim referred to in paragraph 44 was a super-priority right and that a cross-reference should be made to any discussion in the insolvency chapter as to the parties that could challenge the effectiveness of security rights.

L. Future advances

53. It was suggested that it should be made clear that, in the case of instalment contracts, the claim came into existence upon conclusion of the contract and not upon each delivery. The importance of filing the maximum amount secured was also emphasized (see para. 19).

M. After-acquired property

54. It was suggested that paragraph 50 should provide guidance as to the time when priority was obtained with respect to assets acquired after the conclusion of the initial security agreement. In that connection, it was suggested that priority should date back to the time of the initial filing rather than to the time when the debtor or other grantor acquired the property.

N. Priority in proceeds

55. It was suggested that the discussion should relate both to proceeds and fruits (see A/CN.9/512, para. 47).

O. Subordination agreements

56. In response to a question, it was noted that it was important for insolvency law to provide that subordination agreements should be enforced. In some jurisdictions, such a provision was necessary to empower the courts to enforce subordination agreements and insolvency representatives to deal with priority conflicts between the parties to subordination agreements without being exposed to the risk of becoming liable. It was suggested that the draft Guide should include a cross-reference to the relevant section in the draft Insolvency Guide where that matter was discussed. It was also suggested that a distinction might be drawn between subordination agreements between unsecured creditors, waiving the principle of equal treatment, and priority agreements between secured creditors.

P. Relevance of priority prior to enforcement

57. Some doubt was expressed as to the need to retain paragraphs 62 and 63. It was stated that priority was relevant only upon default as it related to the encumbered assets rather than to the secured obligation. In response, it was observed that the draft Guide needed to discuss the licence of the debtor to dispose of the encumbered assets and to pay with the proceeds obligations as they matured, irrespective of priority.

Q. Additional issues

58. A number of suggestions were made with respect to additional issues to be discussed in chapter VII. One suggestion was that the principle of equitable subordination should also be discussed. It was stated that, in view of the possibility that courts might apply that principle and change priority in the case of a violation of the obligation to act in good faith, the draft Guide needed to discuss and discourage it. It was also observed that the issue arose not only in insolvency but also outside insolvency proceedings. In view of the doubt expressed as to whether the matter was relevant outside insolvency proceedings, it was agreed that it could be left to the draft Insolvency Guide.

59. Another suggestion was that the draft Guide should discuss a priority conflict between a secured creditor and a holder in due course of a negotiable instrument or a document of title. While it was noted that the matter was discussed in the context of a conflict between a party that obtained priority by possession and a party that obtained priority by filing (see para. 32), it was suggested that the discussion needed to be expanded and preference be given to negotiable instrument law, as that law was understood in the State enacting legislation based on the draft Guide. Yet another suggestion was that conflicts of priority in fixtures and accessions should also be discussed. There was support for all those suggestions.

R. Summary and recommendations

60. It was noted that the summary and recommendations that were tentative would be revised to take into account the discussion of chapter VII. Examples of paragraphs that needed to be adjusted included: paragraph 64 (pre-commencement priority dealt with in the insolvency chapter), paragraph 65 (emphasis to be placed not only on clear rules but also on workable ones), paragraph 66 (statement as to the efficiency of the filing system to be qualified by referring to conditions, such as cost-efficiency, simplicity, ease of access, centralized registry, infrastructure), paragraph 67 (priority by possession or control, reference to preferential or superior claim, exceptions to first-to-file rule), paragraph 71 (relevant before default and enforcement).

61. After discussion, the Working Group requested the Secretariat to revise chapter VII taking into account the views expressed and the suggestions made.

Chapter IX. Default and enforcement

A. Introduction

62. The substance of paragraphs 1 to 4 was found to be acceptable.

B. Key objectives

63. While there was general support for the substance of the key objectives, it was suggested that, as they addressed several issues reflecting recommendations, they should be merged with the recommendations at the end of chapter IX. With respect to paragraph 9, some doubt was expressed as to whether the ambiguity as to the rights of secured creditors other than the secured creditor taking enforcement action was consistent with the finality principle. It was explained that that ambiguity was due to the need to protect the first-ranking creditor in cases where the second-ranking creditor initiated enforcement action (see A/CN.9/WG.VI/WP.2/Add.9, para. 33).

64. With respect to paragraph 10, it was stated that reference should be made to court involvement before or after an agreement as to enforcement was concluded between the parties. Support was expressed for court involvement after conclusion of such an agreement on enforcement. With respect to paragraph 11, it was observed that it failed to take sufficiently into account the fact that a sale of encumbered assets in an insolvency proceeding would produce less value than a private sale.

C. Default

65. It was agreed that paragraph 13 should simply state that the secured creditor's right to enforce its claim upon default may be affected by provisions of contract law giving the debtor time to cure the default. With respect to paragraph 14, while the need for a fair notice was recognized, the concern was expressed that excessive notice requirements could delay and complicate enforcement. In order to address that concern, it was suggested that the appropriate balance needed to be established between fairness and efficiency of the enforcement system. As a matter of drafting, it was suggested that the word "redemption" of the encumbered assets by the debtor should be replaced by language referring to the debtor paying its debt and obtaining the assets free of the relevant security right.

D. Judicial action

66. With respect to paragraph 18, some doubt was expressed as to the statement that there was no reason to distinguish between possessory and non-possessory security rights with respect to enforcement procedures (see A/CN.9/WG.VI/WP.2/Add.9, para. 43 (i)). It was observed that an obvious difference related to removing the asset from the debtor's control (see A/CN.9/WG.VI/WP.2/Add.9, para. 30). With respect to paragraph 21, it was suggested that additional clarification was needed with respect to out-of-court remedies by moving paragraphs 22, 25, 30 and 32 to 34 to a separate section. It was also stated that the approach to judicial action should depend on the efficiency of the relevant judicial system and that reference should also be made to efficient judicial systems in which out-of-court action might not be necessary. It was also observed that, in some jurisdictions, the degree of court control in the case of out-of-court receivers was limited to the control of the professional accreditation of the person appointed.

67. With respect to out-of-court remedies, the view was expressed that, while they should be available, their efficiency should not be over-estimated, since it depended to a large extent on the judicial system, the general infrastructure and the relevant market conditions. At the same time, it was observed that fears expressed with respect to out-of-court remedies were often exaggerated since they were always subject to public policy considerations (e.g. "breach of peace") and to the consent of the debtor who could, at any time, seek the intervention of the judicial system. It was suggested that all those issues in relation to the judicial system and other infrastructure should be discussed in the draft Guide. As a matter of drafting, it was suggested that the draft Guide should discuss first debtor dispossession, whether by judicial or out-of-court action, and then judicial or out-of-court sale.

68. With respect to paragraph 25, a number of suggestions were made. One suggestion was that a distinction should be drawn between an agreement of the parties choosing a remedy which was not a statutory remedy (e.g. collection rather than sale of a receivable) and an agreement as to how to exercise a contractual or statutory remedy (e.g. notifications, use of certain auction houses, methods of sale). In that connection, the need for flexibility was emphasized. Another suggestion was that agreements as to remedies, concluded after default occurred, might be less objectionable than agreements at the time of the conclusion of the security agreement in which the debtor could be put under pressure to accept a harsh remedy in return for some concession in the security agreement. Yet another suggestion was

that notice to and consent of third parties affected by such an agreement should also be discussed in the draft Guide. In that connection, it was stated that tangibles might need to be treated differently from intangibles.

E. Freedom of parties to agree to the enforcement procedure

69. Several suggestions were made. One suggestion was that freedom of parties to agree to the enforcement procedure should be the general rule, subject to exceptions (e.g. public policy, priority, third party rights and insolvency). Another suggestion was that the focus should be on the timing of the agreement, with an agreement being permitted only after conclusion of the financing contract. Yet another suggestion was that emphasis should be placed on the need for an efficient enforcement mechanism, in which judicial involvement might not be the exclusive or primary procedure.

F. Acceptance of the encumbered assets in satisfaction of the secured obligation

70. A number of suggestions were made. One suggestion was that such an agreement could be permitted after the time of the conclusion of the financing contract. Another suggestion was that the agreement should not affect priority and acceptance of the encumbered assets should be in full or partial satisfaction of the secured obligation. Yet another suggestion was that an agreement that automatically vested ownership of the encumbered assets in the secured creditor should be null and void rather than unenforceable. That suggestion was objected to. Yet another suggestion was that the last sentence in paragraph 26 should be deleted.

71. Yet another suggestion was that, irrespective of whether retention or transfer of title was assimilated to a security right or not, acceptance of encumbered assets in satisfaction of the secured obligation might not apply to those quasi-security devices. In that connection, it was stated that such a remedy would be unfair in situations where the debtor had paid the bulk of the price or the value of the assets exceeded the value of the secured obligations. In response, it was observed that any excess value would be returned to the next creditor in the order of priority and then to the debtor. It was noted that that principle should be emphasized in the draft Guide.

72. In that connection, the Working Group had a discussion about retention and transfer of title devices. It was stated that there were several possibilities, including that those devices would be assimilated into a security right system, not assimilated to that system but made subject to filing (perhaps with the exception of consumer transactions and transactions up to a certain amount) and that the same or different remedies would apply to such devices. It was agreed that the matter needed to be discussed once the Working Group had the opportunity to complete its first reading of the draft Guide.

G. Redemption of the encumbered assets

73. It was suggested that redemption should be clearly distinguished from reinstatement, which was a matter of contract. It was also suggested that redemption should be allowed only in very exceptional and clearly defined situations (for a suggestion to avoid using the term “redemption”, see para. 65).

H. Disposition by the debtor authorized by the grantor

74. A number of suggestions were made. One suggestion was that it should be clarified that such a remedy existed only in some countries. Another suggestion was that one important disadvantage of such a remedy was that it could delay disposition of the asset by the secured creditor. Yet another suggestion was that paragraph 29 should be deleted. After discussion, it was agreed that paragraph 29 could be retained, provided that the disadvantages of disposition by the debtor with the authority of the grantor were clearly set out.

I. Removing the encumbered assets from the grantor's control

75. Several suggestions were made. One suggestion was that paragraph 30 should clarify whether consent of the debtor was required and define the meaning of the notion "breach of peace". Another suggestion was that the need for interim measures of protection to avoid dissipation of assets should be emphasized. Yet another suggestion was that paragraph 30 should discuss repossession in the case of retention or transfer of title arrangements. It was stated that, in the case of such arrangements, repossession without prior court intervention might not be appropriate. Yet another suggestion was that the disadvantages of requiring that a notice of default be given to the debtor might be counter-productive, since it could inadvertently result in permitting the debtor to hide the encumbered assets. Yet another suggestion was that the efficiency of the judicial system and its impact on such a remedy should be discussed in more detail.

J. Sale or other disposition of the encumbered assets

76. It was noted that the substance of paragraphs 32 to 34 had been discussed in the context of the Working Group's discussion on options following default (see paras. 66-68). It was stated that, with respect to receivables, collection, and not only sale or other disposition, should also be discussed.

K. Allocation of proceeds

77. It was suggested that allocation of proceeds between secured creditors and other parties (e.g. joint owners of the encumbered assets) should also be discussed. In addition, it was suggested that the impact of the distribution of proceeds and, in particular, whether rights of other secured parties were purged based on the principle of finality should also be discussed. Moreover, it was suggested that the time of allocation of proceeds should also be considered.

L. Finality

78. In light of the earlier discussion in the Working Group on the issue of finality (see para. 63), it was agreed that paragraph 37 should be revised to consider the advantages and disadvantages of the various systems on the issue of purging security rights other than those of the secured creditor taking enforcement action.

M. Summary and recommendations

79. It was agreed that the summary and recommendations should be revised to take into account the discussion of chapter IX by the Working Group.

80. After discussion, the Working Group requested the Secretariat to revise chapter IX taking into account the views expressed and the suggestions made.

V. Future work

81. The Working Group noted that its third session was scheduled to take place in New York from 3 to 7 March 2003 and its fourth session was scheduled to take place in Vienna from 8 to 12 September 2003 (the latter dates being subject to confirmation by the Commission at its thirty-sixth session).

Notes

[1] *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* (A/56/17), para. 358.

[2] Ibid., *Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 455, and *Fifty-sixth Session, Supplement No. 17* (A/56/17), para. 347.

[3] Ibid., *Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 459.

[4] Ibid., *Fifty-sixth Session, Supplement No. 17* (A/56/17), para. 351.

[5] Ibid., para. 357.

[6] Ibid., *Fifty-seventh Session, Supplement No. 17* (A/57/17), paras. 202-204.