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Security interests

Draft legislative guide on secured transactions

Note by the Secretariat*

Addendum

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Introduction

A. Purpose of the Guide

1. The purpose of the UNCITRAL Legislative Guide on Secured Transactions (hereinafter referred to as “the Guide” or “this Guide”) is to assist States in the development of modern secured transactions (i.e. transactions creating a proprietary security right in movable property; for the definition of “secured transaction”, see para. 19 below) laws with a view to promoting the availability of secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.

2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (particularly small and medium-sized enterprises) and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see the *UNCITRAL Legislative Guide on Insolvency Law*).[1]

3. The Guide seeks to rise above differences among legal regimes to offer pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable, though limited, costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.

5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of payment in the event of non-payment of the secured obligation. As the risk of non-payment is reduced, the availability of credit is likely to increase and the cost of credit is likely to fall.

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[1] United Nations publication, Sales No. E.05.V.10.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. On the other hand, in States that do not have efficient and effective laws, where creditors perceive the legal risks associated with credit transactions to be high, the cost of credit normally increases, as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime, or of an insolvency law regime, under which security rights are recognized, has resulted in the virtual elimination of credit for small and medium-sized commercial enterprises, as well as for consumers.

7. By aiding in the cultivation and growth of individual businesses, a legal regime that promotes secured credit can have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves valuable economic benefits.

8. In order to best promote the availability of secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their movable property to the maximum extent possible to obtain credit. In this regard, the Guide adopts two of the most essential concepts of successful secured transactions laws: the concepts of priority and effectiveness against third parties. The concept of priority allows for the concurrent existence of security rights having different priority status in the same assets. This makes it possible for a business to utilize the value of its assets to the maximum extent possible to obtain secured credit from more than one creditor using the same assets as security, while at the same time allowing each creditor to know the priority of its security right. The concept of the effectiveness of a security right against third parties, in the form of a system allowing, inter alia, the achievement of third-party effectiveness by registration of a simple notice in a quick and inexpensive way, is designed to promote legal certainty with regard to the relative priority status of rights of creditors and thus to reduce the risks and costs associated with secured transactions.

9. The legal regime envisaged in the Guide is a purely domestic regime. The Guide is addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the recognition of security rights and title-based security devices, such as retention of title in tangible property and financial leases, effectively created in other jurisdictions. This would represent a marked improvement for the holders of those rights over the laws currently in effect in many States, under which such rights often are lost once an encumbered asset is transported across national borders, and would go far towards encouraging creditors to extend credit in cross-border transactions, a result that could enhance international trade.

10. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, such as buyers and other transferees of encumbered assets, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence,

that all creditors will accept such a balanced approach and will thereby be encouraged to extend credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately obtain the economic value of the encumbered assets in the event of non-payment by the debtor. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transaction, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since these matters do not lend themselves to unification.

11. In the same spirit, the Guide also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. Another concern is the potential ability of a secured creditor to exercise influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. Yet another concern is that, in some cases, secured creditors may take most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, who may not be in a position to bargain for a security right in those assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, suggests balanced solutions.

12. The Guide builds on the work of UNCITRAL and other organizations. Such work includes the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD "Core principles for a secured transactions law", completed in 1997; the Organization for Harmonization of Business Law in Africa Uniform Act Organizing Securities, prepared in 1997; the study on secured transactions law reform in Asia, prepared by the Asian Development Bank in 2000;[2] the United Nations Convention on the Assignment of Receivables in International Trade[3] (the "United Nations Assignment Convention"), adopted in 2001; the Convention on International Interests in Mobile Equipment, adopted in 2001, and the relevant protocols thereto; the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted by the Hague Conference on Private International Law in 2001; the Organization of American States (OAS) Model Inter-American Law on Secured Transactions, prepared in 2002; the *UNCITRAL Insolvency Guide*, completed in 2004; and the UNIDROIT preliminary draft convention on harmonized substantive rules regarding intermediated securities.

B. Terminology and rules of interpretation

13. The Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any

[2] See *Law and Policy Reform at the Asian Development Bank 2000*, vol. I (Manila, Asian Development Bank, April 2000).

[3] Ibid., Sales No. E.04.V.14.

particular legal system. Even when a term appears to be the same as that found in a particular national law, the Guide does not intend to adopt the meaning of the term in that national law. Rather, the Guide provides definitions giving a specific meaning to each key term. It is important to note that many definitions also have the effect of delimiting the scope of the recommendations in the Guide that use those terms. Some recommendations use terms that are defined in those recommendations and the meaning of some terms defined in this chapter is further elaborated in recommendations that use those terms. Thus, the scope and content of each recommendation depend on the meaning of the defined terms used.

14. The Guide's approach of using defined terms is taken to facilitate precise communication, independent of any particular national legal system, and to enable readers of the Guide to understand its recommendations uniformly, providing them with a common vocabulary and conceptual framework. The definitions should be read with care and should be referred to whenever the defined terms are encountered.

15. While the terms are not of themselves an imperative element of the Guide's recommendations, legislation based on the Guide will typically include specific definitions for the terms that are used. Even if the terms used in the legislation differ from those used in the Guide, the definitions provided in the terminology might nevertheless be used. This would avoid unintended substantive change and would make most likely the uniform understanding of the terms used, from the outset, to maximize uniform interpretation immediately upon the effective date of the new legislation. Use of the terms and, more importantly, the definitions provided in the Guide will also encourage harmonization of the law governing security rights.

16. The word "or" is not intended to be exclusive; use of the singular also includes the plural and vice versa; "include" and "including" are not intended to indicate an exhaustive list; "may" indicates permission and "should" indicates instruction; and "such as" and "for example" are to be interpreted in the same manner as "include" or "including". "Creditors" should be interpreted as including both the creditors in the enacting State and foreign creditors, unless otherwise specified. References to "person" should be interpreted as including both natural and legal persons, unless otherwise specified.

17. Some States may choose to implement the recommendations of the Guide by enacting a single comprehensive statute (a method more likely to produce coherence and avoid errors of omission or misunderstanding), while other States may seek to modify their existing body of law by insertion of specific rules in various places. The Guide refers to the entire body of recommended rules, whichever method is chosen for implementation, as "the law" or "this law".

18. The Guide also uses the term "law" in various other contexts. Except when otherwise expressly provided, throughout the Guide (a) all references to law refer to both statutory and non-statutory law; (b) all references to law refer to internal law, excluding private international law rules (so as to avoid renvoi); (c) all references to "law other than the secured transactions law" refer to the entire body of a State's law (whether substantive or procedural) other than that embodying the law governing secured transactions (whether pre-existing or newly enacted or modified pursuant to the recommendations of the Guide); (d) all references to "the law governing negotiable instruments" refer not only to a special statute or body of law

denominated as "negotiable instruments law" but include also all contract and other general law that might be applicable to transactions or situations involving a negotiable instrument (the same rule applies to similar expressions); and (e) all references to "insolvency law" are similarly all-encompassing, but refer only to law that might be applicable after the commencement of insolvency proceedings.

19. The following paragraphs identify the principal terms used and the core meaning given to them in the Guide. The meaning of these terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms (as is the case, for example, with chapter XI on insolvency; see A/CN.9/631/Add.8). The definitions should be read together with the relevant recommendations. The principal terms are defined as follows:

(a) "Acknowledgment" with respect to proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a draw under an independent undertaking has, unilaterally or by agreement:

(i) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the proceeds under an independent undertaking; or

(ii) Has obligated itself to pay or give value to the secured creditor upon a demand for payment ("draw") under an independent undertaking;

(b) "Acquisition financier", a term used only in the context of the non-unitary approach to acquisition financing rights, means a person that has an acquisition financing right (and, thus, includes a retention-of-title seller, a financial lessor and the obligee under hire-purchase transactions, or a creditor under any other acquisition financing transaction and any other transaction described in subparagraphs (iii) and (iv) of definition (c));

(c) "Acquisition financing right", a term used only in the context of the non-unitary approach to acquisition financing rights, means any of the following rights:

(i) A retention-of-title right;

(ii) The right of a lessor under a financial lease;

(iii) The retained ownership and related rights arising under any arrangement that enables a person to acquire possession or use of tangible property other than negotiable instruments or negotiable documents and whereby pursuant to the arrangement title to that property does not vest irrevocably in the person possessing or using the property until or under the condition that the price is paid; and

(iv) A right under any arrangement by which a creditor that has provided credit to enable a person to acquire possession or use of tangible property other than negotiable instruments or negotiable documents, reserves the right to become the irrevocable owner of the property in satisfaction of the repayment obligation;

(d) "Acquisition financing transferee", a term used only in the context of the non-unitary approach to acquisition financing rights, means the person whose right to assets is subject to an acquisition financing right and, thus, includes a retention-of-title buyer, a financial lessee or a creditor under any other acquisition financing transaction;

(e) "Acquisition secured creditor", in the context of both the unitary and the non-unitary approach to acquisition financing rights, means a secured creditor that has an acquisition security right and, in the context of a unitary approach, includes a retention-of-title seller, financial lessor, hire-purchase lessor or other acquisition financier;

(f) "Acquisition security right", in the context of both the unitary and the non-unitary approach to acquisition financing rights, means a security right in tangible property other than negotiable instruments or negotiable documents that secures the obligation to pay any unpaid portion of the purchase price of the property or an obligation incurred or credit otherwise provided to enable the grantor to acquire the property. An acquisition security right need not be denominated as such. Under the unitary approach, the term includes a creditor's rights in the property under a retention-of-title sale, hire-purchase transaction, financial lease or other acquisition financing transaction;

(g) "Assignee" means the person to which an assignment of a receivable is made;

(h) "Assignment" means the creation of a security right in a receivable and includes an outright transfer of a receivable. The creation of a security right in a receivable includes an outright transfer by way of security;

(i) "Assignor" means the person that makes an assignment of a receivable;

(j) "Attachment to immovable property" means tangible property that is so physically attached to immovable property that, despite the fact that it has not lost its separate identity, is treated as immovable property under the law of the State where the immovable property is located;

(k) "Attachment to movable property" means tangible property that is so physically attached to other tangible property that, despite the fact that it has not lost its separate identity, it is treated as part of that movable property under law other than this law;

(l) "Bank account" means an account that is maintained by a bank into which funds may be deposited or credited. The term includes a checking or other current account, as well as a savings or time deposit account. The term does not include a claim against the bank evidenced by a negotiable instrument;

The right to payment of funds credited to a bank account covers a right to the payment of funds transferred into an internal account of the bank and not applied to any obligations owed to the bank. Funds transferred to the bank by way of anticipated reimbursement of a future payment obligation that the bank has accepted in the ordinary course of its banking business is also covered to the extent that the person that gave the bank instructions has a claim to those funds if the bank does not make the future payment;

(m) "Competing claimant" means:

(i) Another secured creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);

(ii) In the context of the non-unitary approach to acquisition financing rights, the seller, financial lessor or other acquisition financier of the same encumbered asset that has retained title to it;

(iii) Another creditor of the grantor that has a right in the same encumbered asset (e.g. by operation of law, attachment, seizure or similar process);

(iv) The insolvency representative in the insolvency of the grantor (in the chapter on insolvency, reference is made to "the insolvency of the debtor" for reasons of consistency with the terminology used in the *UNCITRAL Legislative Guide on Insolvency Law*); or

(v) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset;

(n) "Confirmer" means a bank or other person that adds its own independent undertaking to that of the guarantor/issuer;

In line with article 6, subparagraph (e), of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit[4] (the "United Nations Guarantee and Stand-by Convention"), a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer;

(o) "Consumer goods" means goods that the grantor uses or intends to use for personal, family or household purposes;

(p) "Control" with respect to proceeds under an independent undertaking exists:

(i) Automatically upon the creation of the security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or

(ii) If the guarantor/issuer, confirmer or nominated person has made an acknowledgment in favour of the secured creditor;

(q) "Control" with respect to a right to payment of funds credited to a bank account exists:

(i) Automatically upon the creation of a security right if the depositary bank is the secured creditor;

(ii) If the depositary bank has concluded a control agreement evidenced by an authenticated record with the grantor and the secured creditor, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent of the grantor; or

(iii) If the secured creditor is the account holder.

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[4] United Nations publication, Sales No. E.97.V.12.

There is no obligation on a depositary bank to enter into a control agreement. In addition, a secured creditor's rights will be subject to the rights and obligations of the depositary bank under law and practice governing bank accounts. Moreover, a control agreement requires the consent of the grantor (as well as of the depositary bank) and the grantor retains the right to deal with the funds in the bank account until the secured creditor instructs the depositary bank otherwise (although in some control agreements, the funds would be blocked from the time of the conclusion of the control agreement). This covers situations where (a) an existing account is transferred to the secured creditor; (b) the secured creditor agrees with the grantor that funds should be deposited to an account to be opened later; and (c) the secured creditor is the only account holder (i.e. not merely a joint account holder);

(r) "Debtor" means a person that owes performance of the secured obligation and includes secondary obligors, such as guarantors of a secured obligation. The debtor may or may not be the person that grants the security right to a secured creditor (see the definition of the term "grantor");

(s) "Debtor of the receivable" means a person liable for payment of a receivable. "Debtor of the receivable" includes a guarantor or other person secondarily liable on the receivable;

A guarantor in an accessory guarantee is not only a debtor of the receivable, the payment of which it has guaranteed, but also a debtor of the receivable that is constituted by the guarantee, as a guarantee is itself a receivable (i.e. there are two receivables);

(t) "Encumbered asset" means tangible or intangible property that is subject to a security right;

(u) "Equipment" means tangible property used by a person in the operation of its business;

(v) "Financial lease" means a lease, at the end of the term of which:

(i) The lessee automatically becomes the owner of tangible property other than negotiable instruments or negotiable documents subject to the lease;

(ii) The lessee may acquire the assets subject to the lease by paying no more than a nominal price; or

(iii) The tangible property subject to the lease has no more than a nominal residual value.

The term includes a hire-purchase agreement.

(w) "Grantor" means a person that creates a security right in one or more of its assets in favour of a secured creditor to secure either its own obligation or that of another person (see the definition of the term "debtor of the receivable"). Under the unitary approach, "grantor" of an acquisition security right includes a retention-of-title buyer, hire-purchase buyer, financial lessee or grantor in a purchase-money lending transaction. Because the general recommendations of the Guide apply not only to security rights in receivables but also to security transfers and outright transfers of receivables, unless otherwise provided, references to the "grantor" in the general recommendations also refer to the "assignor" (see definition of the term "debtor");

(x) "Guarantor/issuer" means a bank or other person that issues an independent undertaking;

(y) "Independent undertaking" means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (including demand, first demand, bank guarantee or counter-guarantee) or any other undertaking recognized as independent by law or practice rules, such as the United Nations Guarantee and Stand-by Convention, the Uniform Customs and Practice for Documentary Credits, the Rules on International Standby Practices and the Uniform Rules for Demand Guarantees;

(z) "Insolvency court" means a judicial or other authority competent to control or supervise insolvency proceedings;

(aa) "Insolvency estate" means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings;

(bb) "Insolvency proceedings" means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor's business conducted according to the insolvency law;

(cc) "Insolvency representative" means a person or body responsible for administering the insolvency estate;

(dd) "Intangible property" means all forms of movable property other than tangible property and includes incorporeal rights, receivables and rights to the performance of obligations other than receivables;

(ee) "Intellectual property" means copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset that is considered to be intellectual property under the domestic law of the enacting State or an international agreement to which it is a party;

(ff) "Inventory" means tangible property held for sale or lease in the ordinary course of the grantor's business and also raw and semi-processed materials (work-in-process);

(gg) "Issuer" of a negotiable document means the person that is obligated to deliver the tangible property covered by the document under the law governing negotiable documents;

In the case of a so-called multimodal bill of lading (if it qualifies as a negotiable document under the applicable law), the "issuer" may be a person that subcontracts various portions of the transport of the goods to other persons but still takes responsibility for their transport and for any damage that might occur during carriage;

(hh) "Knowledge" means actual knowledge;

(ii) "Mass or product" means tangible property other than money that is so physically associated or united with other tangible property that it has lost its separate identity;

(jj) "Money" means currency currently authorized as legal tender by any State. It does not include funds credited to a bank account or negotiable instruments, such as cheques.

(kk) "Negotiable document" means a document, such as a warehouse receipt or a bill of lading, that embodies a right for delivery of tangible property and satisfies the requirements for negotiability under the law governing negotiable documents;

(ll) "Negotiable instrument" means an instrument, such as a cheque, bill of exchange or promissory note, that embodies a right to payment and satisfies the requirements for negotiability under the law governing negotiable instruments;

(mm) "Nominated person" means a bank or other person that is identified in an independent undertaking by name or type (e.g. "any bank in country X") as being nominated to give value under an independent undertaking and that acts pursuant to that nomination and, in the case of a freely available independent undertaking, any bank or other person;

(nn) "Non-possessory security right" means a security right in (i) tangible property that is not in the actual possession of the secured creditor or another person holding the tangible property for the benefit of the secured creditor, or (ii) intangible property;

(oo) "Notice" means a communication in writing;

(pp) "Notification of the assignment" means a communication in writing that reasonably identifies the assigned receivable and the assignee;

(qq) "Original contract" in the context of an assignment means the contract between the assignor and the debtor of the receivable from which the receivable arises. With respect to non-contractual receivables, "original contract" means the non-contractual source of the receivable;

(rr) "Possession", except as the term is used in recommendations 29 and 52-54 with respect to the issuer of a negotiable document, means the actual possession of tangible property by a person or an agent or employee of that person, or by an independent person that acknowledges that it holds for that person. It does not include constructive, fictive, deemed or symbolic possession;

(ss) "Possessory security right" means a security right in tangible property that is in the actual possession of the secured creditor or of another person (other than the debtor or other grantor) holding the asset for the benefit of the secured creditor;

(tt) "Priority" means the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant;

(uu) "Proceeds" means whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or licence of an encumbered asset, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects, damage to or loss of an encumbered asset;

(vv) "Proceeds under an independent undertaking" means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be paid or delivered by the guarantor/issuer, confirmer or nominated person giving value for a draw under an independent undertaking. The term also includes the right to request the purchase by a negotiating bank of a negotiable instrument or a document under a complying presentation. The term does not include:

(i) The right to draw (i.e. to request payment) under an independent undertaking; or

(ii) What is received upon honour of an independent undertaking or upon disposition of proceeds under an independent undertaking (i.e. the proceeds derived from collection or disposition of the proceeds under an independent undertaking).

This definition refers to “proceeds under an independent undertaking” to be consistent with terminology generally used in independent undertaking law and practice. The term as used in the Guide means the right of the grantor as beneficiary of an independent undertaking to receive whatever payment or other value is given under the independent undertaking contingent upon the beneficiary making a presentation complying with the terms and conditions of the independent undertaking. The term does not include the proceeds themselves, i.e. what is actually received upon honour of a drawing by the guarantor/issuer, confirmer or nominated person (a beneficiary’s receipt of value from a negotiating bank should not be characterized as honour or disposition) or upon disposition of a right to proceeds under an independent undertaking.

The term “proceeds under an independent undertaking” refers to a right to receive even though the term “proceeds” as used in independent undertaking law and practice may refer either to the right to receive or to whatever is received under the independent undertaking, and even though the term “proceeds” as used elsewhere in the Guide refers to whatever is received. A security right in proceeds under an independent undertaking (as an original encumbered asset) is different from a security right in “proceeds” (a key concept of the Guide) of assets covered in the Guide;

(ww) “Receivable” means a right to payment of a monetary obligation excluding rights to payment evidenced by a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account;

(xx) “Retention-of-title right”, a term used only in the context of a non-unitary approach, means a seller’s right in tangible property other than negotiable instruments or negotiable documents pursuant to an arrangement with the buyer by which title to the tangible property is not transferred from the seller to the buyer until the condition that the unpaid portion of the purchase price of the property be paid has been satisfied;

(yy) “Secured creditor” means a creditor that has a security right. With respect to a receivable, the term means the “assignee” of the receivable (see the definition of the term “assignment”);

(zz) “Secured obligation” means the obligation secured by a security right;

(aaa) "Secured transaction" means a transaction that creates a proprietary (as opposed to personal) security right in movable property (as opposed to immovable property);

(bbb) "Security agreement" means an agreement between a grantor and a creditor, in whatever form or terminology, that creates a security right;

(ccc) "Security right" means a property right in movable property and attachments that is created by agreement and secures payment or other performance of one or more obligations, regardless of whether the parties have denominated it as a security right. In the context of a unitary approach, the term includes both acquisition security rights and non-acquisition security rights, but in the context of a non-unitary approach it does not include an acquisition financing right. With respect to receivables, security right also means the right of the assignee (see the definition of "assignment" and other definitions below relating to assignments of receivables);

(ddd) "Subsequent assignment" means an assignment by the initial or any other assignee. In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee; and

(eee) "Tangible property" means all forms of corporeal movable property. Among the categories of tangible property are inventory, equipment, attachments, negotiable instruments, negotiable documents and money.

I. Key objectives of an effective and efficient secured transactions regime

20. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime. These objectives are designed to provide a broad policy framework for the establishment and development of such a regime and could be reflected in a preamble of the law enacted by States. These objectives should be taken into account in the interpretation of the law (for such an approach, see, for example, art. 7, para. 1, of the United Nations Assignment Convention).

A. To promote secured credit

21. The primary overall objective of the Guide is to promote low-cost secured credit for persons in jurisdictions that adopt legislation based on the Guide's recommendations, thereby enabling such persons and the economy as a whole to obtain the economic benefits that flow from access to such credit (see para. 2 above).

B. To allow utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of secured transactions

22. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by (a) permitting a broad range of assets (including present and future assets) to serve as encumbered assets; (b) permitting the widest possible array of obligations (including future and conditional and monetary and non-monetary obligations) to be secured by security rights in encumbered assets; and (c) extending the benefits of the regime to the widest possible array of debtors, creditors and credit transactions.

C. To enable parties to obtain security rights in a simple and efficient manner

23. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or action by the parties.

D. To provide for equal treatment of diverse sources of credit and of diverse forms of secured transaction

24. Because healthy competition among all potential credit providers is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to various credit providers, including banks and other financial institutions, and suppliers, as well as domestic and non-domestic creditors.

E. To validate non-possessory security rights

25. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with a mechanism in the form of a public registry for providing notice to third parties as to the possible existence of such security rights.

F. To enhance predictability and transparency with respect to rights serving security purposes by providing for registration of a notice in a general security rights registry

26. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a secured transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns. A primary means of accomplishing this goal is the establishment of a general security rights registry in which notices of security rights are registered.

G. To establish clear and predictable priority rules

27. A security right in assets will have little or no value to a creditor unless the creditor is able to ascertain, at the time a transaction is concluded, the priority of its right in such assets relative to the rights of other creditors (including an insolvency representative). Thus, the Guide proposes the establishment of a general security rights registry and, based on that registry, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

H. To facilitate enforcement of creditors' rights in a predictable and efficient manner

28. A security right will also have little or no value to a secured creditor unless the creditor is able to enforce the security right in a predictable and time- and cost-efficient manner. Thus, the Guide proposes procedures that allow secured creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

I. To balance the interests of affected persons

29. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees of the encumbered assets, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

J. To recognize party autonomy

30. Because an effective secured transactions regime should provide maximum flexibility to encompass a broad array of secured transactions, and also to

accommodate new and evolving forms of secured transactions, the Guide stresses the need to keep mandatory rules to a minimum so that parties may tailor their secured transactions to their specific needs. At the same time, the Guide takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

K. To harmonize secured transactions laws, including private international law rules

31. Adoption of legislation based on the recommendations contained in the Guide will result in harmonization of secured transactions laws (through the adoption of similar substantive laws that will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade and the movement of goods and services across national borders. Furthermore, to the extent complete harmonization of national secured transactions laws might not be achieved, private international law rules would be particularly useful to facilitate cross-border transactions. In any event, private international law rules would be useful in order, for example, to help secured creditors to determine how to make their security rights effective against third parties (i.e. under the law of the location of the encumbered assets, the law of the location of the grantor or another law).

II. Scope of application and other general rules

A. Scope of application

32. The regime envisioned by the Guide is intended to be a single, comprehensive regime for secured transactions, affecting the widest possible array of assets, parties, secured obligations, security rights and other rights and financing practices.

1. Assets, parties, obligations and security and other rights

33. The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of asset are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, both tangible and intangible (see A/CN.9/631, recommendation 2, subpara. (a)), with the exception of assets specifically excluded (see A/CN.9/631, recommendations 4-6).

34. The Guide covers all types of movable property and attachment, tangible or intangible, present or future, including inventory, equipment and other goods, contractual and non-contractual receivables, contractual non-monetary claims, negotiable instruments, negotiable documents, rights to payment of funds credited to a bank account, proceeds under an independent undertaking and intellectual property. With respect to receivables (which do not include negotiable instruments, negotiable documents and bank accounts; see the definition of "receivable" in para. 19 above), the general recommendations, as supplemented by the recommendations on receivables, apply both to (a) contractual and non-contractual

receivables, except that recommendations 24 (Effectiveness of a bulk assignment of receivables and an assignment of future, parts of and undivided interests in receivables) and 111 (Representations of the assignor) do not apply to non-contractual receivables; and (b) contractual non-monetary obligations. However, the rights of obligors of contractual non-monetary obligations are subject to law other than the law recommended in the Guide.

35. The Guide stresses the need to enable a grantor to create security rights not only in its existing assets but also in its "future" or "after-acquired" assets (i.e. assets acquired by the grantor or created after the conclusion of the security agreement), without requiring the grantor or secured creditor to sign any additional documents or to take any additional action at the time such assets are acquired or created. This approach is consistent, for example, with the United Nations Assignment Convention, which provides for the creation of security rights in future receivables without requiring any additional steps to be taken. In addition, the Guide recommends recognition of a security right in all existing and future assets of a grantor through a single security agreement, a concept that already exists in some legal systems as an "enterprise mortgage", as a combination of fixed and floating charges, or as an "all-asset security right".

36. Any person, physical or legal, may be a debtor, grantor or secured creditor under the Guide. Unless specifically indicated otherwise, the Guide also applies to consumers, inasmuch as there is no reason why consumers should be deprived of the benefits of the regime envisaged in the Guide. However, to the extent a rule of the regime envisaged in the Guide conflicts with consumer-protection law, consumer-protection law would prevail. States that do not have a body of law for the protection of consumers may wish to consider whether the enactment of a law based on the recommendations of the Guide would affect the rights of consumers and would thus require the introduction of consumer-protection legislation (see A/CN.9/631, recommendation 2, subpara. (b)).

37. The Guide also recommends that a broad range of obligations, monetary and non-monetary, may be secured. In addition, the Guide is intended to cover a broad range of transactions that serve security functions, including those related to possessory and non-possessory security rights (see A/CN.9/631, recommendation 2, subparas. (c) and (d)).

38. The Guide deals with security rights created by agreement. However, it contains references to other rights, such as those provided by statute or judicial process, when the same property is subject to both security rights created by agreement and statutory or other rights, and the law must provide for the relative priority of such rights (see A/CN.9/631, recommendations 89-92).

39. To ensure a comprehensive coverage of all devices that serve security functions, the Guide also deals with rights that, while they are not denominated as security rights, nevertheless serve security purposes (e.g. transfers of title in tangible property for security purposes, outright transfers of receivables for security purposes and the various forms of retention of title (see A/CN.9/631, recommendation 2, subpara. (e)).

40. The only devices dealt with in the Guide that do not serve security functions, are those that involve purely outright transfers of receivables. This approach is justified by the need to avoid characterization issues and to ensure that the registry

system and the priority rules of the Guide apply to all assignments of receivables (see paras. 41-45 below).

2. Outright transfers of receivables

41. The Guide does not apply to devices that do not serve security functions. The only exception to this rule relates to purely outright transfers of receivables, to which the Guide applies in order to ensure that all assignments of receivables are subject to the same rules (see A/CN.9/631, recommendations 3 and 162-164). However, as the definition of "receivable" (for the definition of "receivable", see para. 19 above), excludes rights to payment under a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account, the Guide does not apply to purely outright transfer of such assets (the Guide applies, though, to transfers of such assets if they are made for security purposes).

42. Purely outright transfers of negotiable instruments, proceeds under an independent undertaking and rights to payment of funds credited to a bank account have been excluded because they raise different issues and would require special rules (the same considerations would apply to non-intermediated securities, if they were to be covered by the Guide). Moreover, in the case of receivables, a security transfer and an outright transfer would compete for priority based on the order of registration. However, the situation is different with negotiable instruments, proceeds under an independent undertaking and rights to payment of funds credited to a bank account. In the case of a negotiable instrument, a secured creditor can always obtain a superior right by taking possession of the instrument. Similarly, with respect to proceeds under an independent undertaking and rights to payment of funds credited to a bank account, a secured creditor can always obtain a superior right by control.

43. While principles of secured transactions law can easily be made applicable to the outright transfer of a promissory note, and perhaps a bill of exchange other than a cheque, in a manner similar to the Guide's coverage of the outright transfer of receivables, those principles do not apply well to the outright transfer of cheques. The latter topic is sufficiently covered by the law of negotiable instruments and the law of bank collections.

44. An enacting State that wishes to expand the scope of its secured transactions law to apply to outright transfers of negotiable instruments that are either promissory notes or bills of exchange (and to expand its definition of "security right" to cover the right of the transferee in such a transaction) might wish to consider providing that a security right that is an outright transfer of such a negotiable instrument is automatically effective against third parties upon the transfer. Such a rule would avoid disrupting existing financial practices.

45. With respect to the priority of such a security right, the general principles of priority would apply. Most particularly, the general principle in recommendation 99 would govern. As in the case of an outright transfer of a receivable, the outright transferee of such a negotiable instrument should be able to enforce the instrument without further consent of the assignor subject to the rights of the obligors on the negotiable instrument as described in chapter X on post-default rights (see A/CN.9/631/Add.7).

3. Aircraft, railway rolling stock, space objects, ships, securities and intellectual property

46. The Guide does not apply to assets, such as aircraft, railway rolling stock, space objects and ships, as well as other categories of mobile equipment, in so far as such property is covered by national laws or international agreements to which the State enacting legislation based on the Guide is a party and the matters covered by this law are addressed in such national laws or international agreements (see A/CN.9/631, recommendation 4, subpara. (a)). The reference to aircraft, railway rolling stock, space objects and ships should be understood pursuant to the meaning of those terms in national law or international conventions dealing with them.

47. In view of the increasing importance and economic value of intellectual property assets to businesses seeking to obtain secured credit, the Guide applies in principle to security rights in intellectual property. However, as the recommendations have not been prepared with intellectual property issues in mind, in the case of any inconsistencies with national law or international agreements to which a State is a party, the Guide would not apply (see A/CN.9/631, recommendation 4, subpara. (b)). In order to avoid such inconsistencies, enacting States should examine their existing intellectual property laws and national laws or international agreements to which the State is a party and, if the recommendations of the Guide are inconsistent with any such laws or conventions [and the specific matters covered by the Guide's recommendations are addressed in such national laws and international agreements], the State's secured transactions law should confirm that those existing laws and conventions govern such issues. In considering whether any adjustments of the recommendations as they apply to security rights in intellectual property are appropriate, a State should analyse each case on an issue-by-issue basis and should have proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with its national laws and international agreements.

48. Recommendation 4, subparagraphs (a) and (b), have been prepared against the background of whether there exist relevant special laws and international agreements that address the special matters covered by this law. For example, most countries have registries and detailed rules on security and other rights in ships, aircraft and the other types of mobile equipment described in recommendation 4, subparagraph (a). The registries are either recent or have been kept current as a result of the need for financing of these types of property. The special laws and international agreements for mobile goods all cover, in varying degrees of precision, security rights. In contrast, various types of intellectual property are often not registered, or the registries are only evidence that a right has been issued or recognized by the Government and are not designed for the registration of security rights. In addition, some types of intellectual property have not traditionally been the subject of security rights and intellectual property law does not typically address the special matters covered by this law.

49. In addition, the Guide does not cover security rights in securities because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. The substantive law issues relating to security and other rights in securities held with an

intermediary are dealt with in a draft convention being prepared by the International Institute for the Unification of Private Law (Unidroit). The law applicable to rights in [intermediated] securities is not addressed in the Guide since they are dealt with in the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary. [However, the Guide does cover non-intermediated securities because of the importance of such securities to secured transactions involving small- and medium-sized businesses (see A/CN.9/631, recommendation 4, subpara. (c))].

[*Note to the Commission: If the Commission decides that, pending future work on non-intermediated securities, such securities should be covered in the Guide, language would have to be included in recommendation 4, subparagraph (c), tracking the language of subparagraph (a) or (b), to safeguard the application of certain provisions of securities law at least until the necessary asset-specific recommendations on non-intermediated securities are prepared. In addition, non-intermediated securities would have to be excluded from the definition of "receivables" to ensure that the rules on receivables do not apply to such securities. Moreover, reference would need to be made to the definitions of "securities" and "intermediated securities" contained in the Unidroit preliminary draft convention on substantive rules regarding intermediated securities (see Unidroit document Study LXXVIII-Doc. 57, November 2006, article 1, subparas. (a) and (b)).*]

50. The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by Unidroit and the Hague Conference on Private International Law, as well as relevant texts prepared by UNCITRAL, such as the United Nations Assignment Convention and the *UNCITRAL Insolvency Guide* (see para. 12 above).

4. Immovable property

51. Immovable property (with the exception of attachments to immovable property, which can be subjected to security rights covered by the Guide) is excluded as it raises different issues and is subject to a special title registration system indexed by asset and not by grantor.

52. Although immovable property is excluded from the scope of the Guide as an originally encumbered asset, it may nevertheless be affected by the Guide's recommendations. For example, if a security right in a mortgage secures a receivable, negotiable instrument or other intangible asset, and the receivable, negotiable instrument or other intangible asset is assigned, the security right in the mortgage follows. This rule does not affect any third-party rights, priority and enforcement requirements existing under immovable property law (see A/CN.9/631, recommendation 26).

5. Proceeds of excluded types of asset

53. If an asset is excluded from the scope of the Guide, law other than the secured transactions law should determine whether a security right in that asset nevertheless confers a security right in types of proceed to which the secured transactions law does apply (e.g. receivables representing proceeds of immovable property). Under the Guide, if such other law provides that a security right in such proceeds does exist, then the secured transactions law applies to that security right, except to the

extent that the other law applies to [the third-party effectiveness, priority or enforcement of that security right][that security right] (see A/CN.9/631, recommendation 6).

6. Other exceptions

54. Because the objectives of the Guide are best achieved by a comprehensive secured transactions regime, the Guide recommends that any other exceptions to its scope of application not specifically set out in the Guide should be limited and, if there are any such exceptions, they should be set out in the law in a clear and specific way (see A/CN.9/631, recommendation 7).

B. Other general rules

1. Party autonomy

55. In modern secured transactions regimes, great emphasis is placed on party autonomy, namely the ability of the parties to derogate from, or vary, particular rules of the secured transactions regime except as limited by certain specified mandatory rules that reflect strong policy considerations. Modern secured transactions regimes also make it clear, however, that such agreements do not affect the rights of third parties that are not parties to the agreement. Such an approach is necessary in order to give the parties to secured transactions the greatest flexibility possible so as to enable them to tailor their transactions to meet their specific needs in a way that is consistent with the public policy of the enacting State. This is one of the most important ways in which a secured transactions regime can promote secured credit. The Guide adopts this approach (see A/CN.9/631, recommendation 8).

2. Electronic communications

56. Modern secured transactions regimes not only reflect modern concepts of secured transactions law, but also accommodate modern business practices by facilitating electronic communications. In this spirit, and consistent with article 9, paragraphs 2 and 3, of the United Nations Convention on the Use of Electronic Communications in International Contracts[5] and articles 6 and 7 of the UNCITRAL Model Law on Electronic Commerce,[6] the Guide contains a number of recommendations recognizing the ability of parties to conduct business using electronic communications (see A/CN.9/631, recommendations 9 and 10; see also article-by-article remarks on the United Nations Electronic Contracting Convention, paras. 143-165,[5] and the *UNCITRAL Model Law on Electronic Commerce with Guide to Enactment 1996* with additional article 5 bis as adopted in 1998, paras. 47-61).[6]

[5] See United Nations publication, Sales No. E.07.V.2.

[6] Ibid., Sales No. E.99.V.4.

C. Examples of financing practices covered in the Guide

57. Short examples of the types of secured credit transaction that the Guide is designed to encourage and to which reference is made throughout the Guide to illustrate specific points are set out below. These examples represent only a few of the numerous forms of secured credit transaction currently in use and an effective secured transactions regime must be sufficiently flexible to accommodate many existing methods of financing, as well as methods that may evolve in the future.

1. Inventory and equipment acquisition financing

58. Businesses often obtain financing for specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the tangible property (inventory and equipment) purchased. In other cases, the financing is provided by a lender. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller retains title or the lender is granted a security right in the tangible property purchased to secure the repayment of the credit or loan.

59. Here is an illustration of acquisition financing: ABC Manufacturing Company (ABC), a manufacturer of furniture, wishes to acquire certain inventory and equipment for use in manufacturing operations. ABC desires to purchase paint (constituting raw materials and, therefore, inventory) from Vendor A. ABC also wishes to purchase certain drill presses (constituting equipment) from Vendor B and certain conveyor equipment from Vendor C. Finally, ABC wishes to lease certain computer equipment from Lessor A.

60. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within 30 days of Vendor A's invoice to ABC, and ABC grants to Vendor A a security right in the paint to secure the purchase price. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the drill presses within 10 days after they are delivered to ABC's plant. ABC obtains a loan from Lender A to finance the purchase of the drill presses from Vendor B, secured by a security right in the drill presses. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the right to payment of funds credited to the bank account as additional security for the repayment of the loan.

61. Under the purchase agreement with Vendor C, ABC is required to pay the purchase price for the conveyor equipment when it is installed in ABC's plant and rendered operational. ABC obtains a loan from Lender B to finance the purchase and installation of the conveyor equipment from Vendor C, secured by a security right in the conveyor equipment.

62. Under the lease agreement with Lessor A, ABC leases the computer equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a "financial lease". Under some forms of financial lease, title to the leased property is transferred to the lessee

automatically at the end of the lease term. A financial lease is to be distinguished from what is usually called an "operating lease". Under an operating lease, the leased property is expected to have a remaining useful life at the end of the lease term and the lessee does not have an option to purchase the leased property at the end of the lease term for a nominal price, nor is title to the leased property transferred to the lessee automatically at the end of the lease term.

63. In each of the above four cases, the acquisitions are made possible by means of acquisition financing provided by another person (seller, lender or financial lessor) who holds rights in the acquired property for the purpose of securing the acquisition financing granted. As the illustrations make clear, acquisition financing can occur with respect to both inventory and equipment.

2. Inventory and receivable revolving loan financing

64. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

65. One highly effective method of providing such working capital is a revolving loan facility. Under this type of credit facility, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs. The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Thus, borrowings and repayments are frequent (though not necessarily regular) and the amount of the credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, processing inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower, and helps the borrower to avoid borrowing more than it actually needs.

66. Here is an illustration of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving loan facility to ABC to finance this process. Under the loan facility, ABC may obtain loans from time to time in an aggregate amount of up to 50 per cent of the value of its inventory that Lender B deems to be acceptable for borrowing (based upon the type and quality of the inventory, as well as other criteria) and of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the debtors of the receivables). ABC is expected to repay these loans from time to time as it receives payments from its customers. The loan facility is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the right to payment of funds credited to the bank account into which customer payments (i.e. the proceeds of inventory and receivables) are deposited.

3. Factoring

67. Factoring is a highly effective form of receivables financing that can trace its roots back thousands of years. In general, factoring involves the outright purchase of receivables from the grantor, as seller (assignor) to the factor (assignee). Such an outright transfer of receivables falls within the definition of a security right for purposes of the Guide (for the definition of "security right", see para. 19 above).

68. There are a number of different types of factoring arrangement. The factor may pay a portion of the purchase price for the receivables at the time of the purchase ("discount factoring"), only when the receivables are collected ("collection factoring"), or on the average maturity date of all of the factored receivables ("maturity factoring"). The assignment of the receivables can be with or without recourse to the assignor ("recourse" and "non-recourse" factoring) in the event of non-payment of the receivables by the debtors of the receivables (i.e. the customers of the assignor). Finally, the debtors of the receivables may be notified that their receivables have been the subject of factoring ("notification factoring"), or they may not be so notified ("non-notification factoring"). When notice is given to the customers, it is often accomplished by requiring the assignor to place a legend on the invoices that the assignor sends to its customers. The factor may also perform various services for the assignor in respect of the receivables, ranging from approving and evaluating the creditworthiness of the debtors of the receivables, performing bookkeeping duties and engaging in collection efforts with respect to receivables that are not paid when due. These services can provide a useful benefit to companies that do not have their own credit and collection departments.

69. Here is an illustration of a typical factoring arrangement: ABC enters into a discount factoring arrangement with Factor, pursuant to which Factor agrees to purchase receivables that Factor deems to be creditworthy. Factor advances to ABC an amount equal to 90 per cent of the face value of such receivables, holding the remaining 10 per cent as a reserve to cover potential customer claims and allowances that would reduce the value of the receivables. The factoring arrangement is with notification to ABC's customers.

4. Securitization

70. Another highly effective form of financing involving the use of receivables is securitization. Securitization is a sophisticated form of financing under which a business enterprise can obtain less expensive financing based on the value of its receivables by transferring them to a wholly owned "special purpose vehicle" ("SPV") that will issue securities in the capital markets secured by the stream of income generated by such receivables. For example, this technique is commonly used in situations where a company's receivables consist of credit card receivables, rents or home mortgages, although the securitization of many other types of receivables is also possible. Securitization transactions are complex financing transactions that are also dependent upon a jurisdiction's securities laws as well as its secured transactions laws.

71. Securitization is intended to lower the cost of financing because the SPV is structured in a way to make the risk of its insolvency "remote" (e.g. theoretically not possible) by restricting the amount of debt that the SPV can incur. That significantly reduces one risk that the lender has to take into account when deciding

what interest rate to charge for the loan. In addition, because the source of credit is the capital markets rather than the banking system, securitization can generate greater amounts of credit than bank loans and at lower costs than the normal bank loan costs.

72. Here is an illustration of a securitization transaction: an SPV is created by a subsidiary of an automobile manufacturer to purchase automobile leases from automobile dealers throughout a geographically defined market. The automobile leases are purchased from the dealers for a discount from the projected value of the payment streams expected to be generated by such leases. The SPV then issues debt securities, under applicable securities laws, to investors in the capital market secured by such income stream. As payments are made under the leases, the SPV will use such proceeds to make payments on the debt securities.

5. Term loan financing

73. Businesses often need financing for large, non-ordinary-course-of business expenditures, such as the acquisition of significant equipment or the acquisition of a business. In these situations, businesses generally seek loans that are repayable over a fixed period of time (with principal being repaid in monthly, quarterly or other periodic instalments pursuant to an agreed-upon schedule or in a single payment at the end of the loan term).

74. As is the case with many other types of financing, a business that does not have strong, well-established credit ratings will have difficulty obtaining term loan financing, unless the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, immovable property is the only type of asset that typically is accepted by lenders to secure term loan financing and, as a result, in such States term loan financing is often not available for other important asset types, such as equipment or the enterprise value of an entire business. This is most likely the case in States that do not have a modern secured transactions regime. However, many businesses, in particular newly established businesses, do not own any immovable property and, therefore, may not have access to term loan financing. In other States, term loans secured by movable property, such as equipment, intellectual property and the enterprise value of the business, are common.

75. Here is an illustration of this type of financing: ABC desires to expand its operations and purchase a business. ABC obtains a loan (predicated on the value of, and secured by, substantially all of the assets of the business being acquired) from Lender C to finance such acquisition. The loan is repayable in equal monthly instalments over a period of 10 years and is secured by existing and future assets of ABC and the entity being acquired.

6. Transfer of title for security purposes

76. In States that honour a form of transfer of ownership even when it does not entail a transfer of possession and is done for financing purposes, a transaction denominated as a transfer of title by way of security (or sometimes as a "fiduciary" transfer of title) is recognized. These transactions are essentially non-possessory

security rights, and they are primarily used in States where the secured transactions law has not yet generally recognized non-possessory security rights.

7. Sale and leaseback transactions

77. A sale and leaseback transaction provides a method by which a company can obtain credit based upon its existing tangible property (usually equipment) while still retaining possession and the right to use the tangible property in the operation of its business. In a sale and leaseback transaction, the company will sell its assets to another person for a specific sum (which the company may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement. Often, the lease is a "financial lease" as opposed to an "operating lease".

D. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.*]

III. Basic approaches to security

A. General remarks

1. Introduction

78. Over time, a broad variety of legal institutions have been developed by different States to encourage lenders and sellers to extend credit to borrowers and buyers. Often, States have enacted special statutory rights for lenders and sellers so as to encourage them to extend credit. Commonly, States have also established regimes to enable creditors and debtors to contract between themselves for special rights. In both cases, the objective was to give the creditor a preference over other creditors in the distribution of the proceeds generated by the seizure and sale of a debtor's property in the event the debtor failed to perform the promised obligation. These various types of rights can, broadly speaking, be understood as security rights (for the definition of "security right", see para. 19 above).

79. The main purpose of this chapter is to provide a survey of the major approaches to affording security to creditors. The chapter discusses the advantages and disadvantages of each approach to the immediate parties involved (i.e. creditor and grantor) and to third parties and outlines the major policy options for legislators in selecting among the various possible approaches. The chapter also stresses the reasons why modernization of the law in this area is necessary in order to promote secured credit and the contexts in which the need for modernization is most pressing.

80. In general terms, the devices that are currently being used for purposes of security fall into three broad categories: first, specific devices designed for, and openly denominated as, security (see sect. A.2 below); second, title (ownership) devices combined with various types of contractual arrangement (see sect. A.3 below); and third, integrated, comprehensive security devices that comprise a functionally defined generic concept of a security right (see sect. A.4 below).

81. As noted, in many States today, not all legal devices used by lenders, sellers and other parties to extend credit are based on an agreement. Some arise by operation of law. The more important of these will be noted in each section below, but since statutory security rights are, for the most part, outside the scope of this Guide (with the exception of chapter VII on priority; see A/CN.9/631/Add.4), the following discussion will focus on security devices based on an agreement.

2. Instruments traditionally designed for security

(a) Security rights in tangible property

82. Most States distinguish between security rights in tangible property and security rights in intangible property (for the definitions of "intangible property" and "tangible property", see para. 19 above). Because tangible property may be the subject of physical possession, and because many States attach significant legal consequences to the possession of tangible property, it is often the case that States permit types of security right to be taken in tangible property that are not available for intangible property.

83. With respect to security rights in tangible property, most States draw a distinction between possessory and non-possessory security rights (for the definitions of "non-possessory security right" and "possessory security right", see para. 19 above). In the case of possessory security rights, possession of the encumbered asset is transferred to the secured creditor or a third party, or to a person acting on behalf of the secured creditor. In the case of non-possessory security rights, the grantor, which is usually the debtor but can also be a third party, retains possession of the encumbered asset (for the definitions of "debtor", "encumbered asset", "grantor" and "secured creditor", see para. 19 above).

(i) Pledges

84. By far the most common type of security right in tangible property is the pledge. Traditionally, a pledge requires for its validity that the grantor relinquish possession of the encumbered asset. Today, many States have extended the term "pledge" to situations where the grantor retains physical possession of the encumbered asset. In this Guide, these modern types of pledge are considered to be non-possessory security rights and not pledges.

85. An ordinary pledge arises where the grantor effectively gives up possession of the encumbered asset to the secured creditor or to a third party agreed upon by the parties (e.g. a warehouse). The actual holder may also be an agent or trustee that holds the security in the name or for the account of the creditor, or a syndicate of creditors. The required dispossession of the grantor must not only occur when the security right is created, but must also be maintained during the duration of the pledge. The return of the encumbered asset to the grantor usually extinguishes the pledge.

86. In many States, dispossession need not always require physical removal of the encumbered assets from the grantor's premises, provided that the grantor's access to the assets is precluded in another way. This can be achieved, for example, by giving to the secured creditor the keys to the warehouse in which the encumbered assets (merchandise or raw materials) are stored, provided that doing so prevents any unauthorized access by the grantor. The same result can be achieved by delivering the encumbered assets to a third party. For example, an independent "warehousing" company may be engaged to exercise control over the encumbered assets, as agent for the secured creditor, on the grantor's premises. Under such an arrangement (sometimes known as "field warehousing"), the encumbered assets are stored in an area of the grantor's premises that is delineated or in some manner under the exclusive control of the warehousing company. For these types of arrangement to be valid, several conditions must usually be fulfilled. It must be obvious to a third party that the grantor does not have free access to the encumbered assets. In addition, there cannot be any unauthorized access by the grantor to the area in which the pledged assets are stored. Furthermore, the employees of the warehousing company cannot work for the grantor. If they are drawn from the grantor's workforce because of their expertise or for other reasons, their terms of employment must be adjusted so that they no longer work for the grantor.

87. While most pledges are taken over items of tangible property, tangible property also embraces a wider set of property. Assets of a special nature, such as documents and instruments (whether negotiable or non-negotiable), embody rights in tangible property (e.g. bills of lading or warehouse receipts) or in intangible payment rights (e.g. negotiable instruments). In such cases, the grantor is dispossessed through the transfer of physical possession of the document or instrument to the secured creditor.

88. As a security right, the pledge presents five important advantages for the secured creditor, arising from the fact that the grantor is dispossessed and the secured creditor has actual possession of the encumbered assets. First, the grantor is unable to dispose of the pledged assets without the secured creditor's consent. Second, the secured creditor does not run the risk that the actual value of the pledged assets will be reduced through the grantor's failure to provide any necessary upkeep or maintenance. Third, in cases where the creditor can use the pledged assets, the parties will often agree that the creditor may do so as long as it takes proper care of them. Fourth, if the pledged asset is an instrument that bears interest payable to the holder, the pledge facilitates the creditor's collection of the repayment obligation as instalments come due. Fifth, if enforcement becomes necessary, the secured creditor is saved the trouble, time, expense and risk of having to seek to obtain delivery of the encumbered assets from the grantor.

89. The pledge also has advantages for third parties, especially when these third parties are the grantor's other creditors. The required dispossession of the grantor avoids any risk of creating a false impression of the grantor's wealth (e.g. that the grantor actually owns the pledged assets or owns them free of any encumbrances) and also minimizes the risk of fraud.

90. On the other hand, the pledge also has major disadvantages. The greatest disadvantage for the grantor is the required dispossession itself, which precludes the grantor from using the encumbered assets in its business. This disadvantage is acute in situations where possession of the encumbered assets is necessary for commercial

grantors to generate the income from which to repay the loan, as is the case, for example, with raw materials, semi-finished goods (work-in-process), equipment and inventory. This disadvantage alone makes the pledge economically impractical in many business contexts. Another important disadvantage is that assets that do not exist or in which the grantor does not have rights at the time of the pledge, cannot be pledged. This means that a number of practices, such as inventory financing on the basis of a revolving credit facility, cannot be accommodated.

91. For the secured creditor, the pledge has the disadvantage that the secured creditor has to store, preserve and maintain the encumbered assets, unless a third party assumes this task. Where secured creditors themselves are neither able nor willing to perform these tasks, entrusting third parties to do so will involve additional costs that will be directly or indirectly borne by the grantor. Another disadvantage is that a secured creditor in possession of encumbered assets (e.g. a pledgee or holder of a warehouse warrant or a bill of lading) may, depending upon the type of asset involved, be exposed to potential liability in various circumstances for loss or damage caused by the encumbered assets, which may exceed the amount of the credit extended, as is the case where the encumbered asset causes contamination of the environment (see chapter IV on creation of a security right; para. 200 below).

92. However, where the parties are able to avoid these disadvantages, the pledge can be utilized successfully and efficiently as a security device. There are two major fields of application. The first field of application is where the encumbered assets are already held by, or can easily be brought into the possession of, a third party, especially a person, such as a warehouse, engaged in the business of maintaining possession of assets owned by other persons. The second field of application is negotiable instruments and negotiable documents, which can be easily held by the secured creditor itself.

(ii) Right of retention of possession

93. Although statutory rights of retention of an asset are generally outside the scope of this Guide (with the exception of chapter VII on priority; see A/CN.9/631/Add.4), they are briefly discussed here, since they secure payment of an obligation. Many States have extensive regimes governing statutory retention rights. Typically, these regimes cover carriers, warehouses, repairers and improvers. In some States, lawyers, accountants, architects and other professionals are also given a right of retention over documents belonging to their clients. All of these types of right of retention arise from the general legal principle of contract law that a party is not required to perform its obligation until the other party is ready, willing and able to perform the correlative obligation. Most of these types of legal retention right do not give the retainer any special enforcement rights, and some do not even permit the retainer that seizes and sells the retained property to claim a priority in the proceeds of the sale in the context of enforcement.

94. In addition to these limited statutory rights of retention, many States permit contracting parties to extend the scope of the general legal principle and to agree that, should one of them be in breach of a contractual obligation, the other may withhold its own performance even when the performance relates to a different contract between the parties. In particular, these States permit a party to withhold an asset that, under the terms of some other contract, the withholding party is obliged

to deliver to the party in breach. For example, a bank need not return a negotiable document (such as a bill of lading) or negotiable instrument (such as a bill of exchange or a promissory note) that it holds for its customer or allow withdrawals from the customer's bank account, if the customer is in default on repayment of a credit and had agreed to grant the bank a right of retention. Where such a right of retention is reinforced by a valid power to sell the retained item, some legal systems regard such a reinforced right of retention as a type of pledge, although the method of its creation deviates from that of the pledge proper. Alternatively, a reinforced right of retention may be regarded as having some of the effects of a pledge. The most important consequence of such assimilation to a pledge is that the creditor in possession has a priority in the assets retained, unless they are subject to an earlier created and effective security right not effected by possession.

(iii) Non-possessory security rights

95. As noted above (see para. 90), a pledge in tangible property required for production or sale (such as equipment, raw materials, semi-finished goods and inventory) is economically impractical. In the case of a commercial grantor, the grantor must have possession of these goods in order to operate its business. Without access to the goods and the right to dispose of them, the grantor would not be able to earn the necessary income to repay the loan.

96. To address this problem, States, especially in the second half of the twentieth century, began to recognize security rights in movable property outside the narrow confines of pledges. While in some cases this recognition was reflected in the enactment of new laws, in many cases it resulted from practice and court decisions. Although some States introduced a new security right encompassing various arrangements serving security purposes, most States continued the tradition of the nineteenth century (which disregarded an earlier, more liberal attitude) and insisted on the possessory pledge as the only legitimate method of creating security in movable property. During the twentieth century, legislators and courts in many of those States have come to acknowledge the urgent economic need to provide for some form of non-possessory security right.

97. Individual States attempted to find appropriate solutions according to particular local needs and in conformity with the general framework of their legal system. The result is a diverse range of solutions. An external indication of the existing diversity is the variety of names for the relevant devices, sometimes differing even within a single State. The more common names and techniques are fictive dispossession of the grantor, non-possessory pledge, registered pledge, *nantissement*, warrant, *hypothèque mobilière*, contractual privilege, bill of sale, chattel mortgage, floating charge and trust receipt. That is, while some States sought to create a denominated non-possessory security device over movable property, other States simply modified the rules governing existing devices like the pledge, in order to permit non-possessory security rights.

98. An even more relevant feature of these legislative reforms is that most were conceived as limited responses to particular problems and were therefore given a restricted scope of application. For example, in some States, there is one type of non-possessory security device applicable to business and commercial equipment, another applicable to the financing of raw materials and a third only applicable to retail inventory. Only a few States have enacted a general statute creating a

non-possessory security right applicable to all forms of movable property. Furthermore, some States have different sets of legislation on non-possessory security rights depending on the type of business enterprise in question: one dealing with security for financing of industrial and artisan enterprises, another with security for financing of farming, fishing and fishing enterprises, another with security for financing of mining and extractive industries, and a fourth dealing with transactions between individuals. Finally, in many States, there is a variety of statutes on non-possessory security rights, each covering only a small economic sector, such as the acquisition of cars or farm machinery, or the production of films.

99. Some States have addressed the matter through a device known as a “fixed charge” or a “floating charge”. Under this type of device, a security right is denominated as a “fixed charge” or a “floating charge” depending upon the degree of control that the secured creditor exerts with respect to the encumbered asset. In general, the creditor has a fixed charge on an encumbered asset if the grantor is not permitted to sell or otherwise dispose of the asset without the creditor’s consent (generally the case with equipment that the grantor uses in its business) and has a floating charge on an encumbered asset if the grantor is permitted to sell or otherwise dispose of the asset without the consent of the secured creditor (generally the case with inventory that the grantor is free to sell in the ordinary course of its business). The relevance of the difference between a fixed charge and a floating charge on an asset relates to the priority of the charge: a fixed charge generally represents a paramount charge on the asset, while a floating charge may be subject to certain preferential claims in favour of tax authorities and other third parties, or a carve-out in favour of unsecured creditors (see also para. 196 below).

100. In some States, there is some reluctance to allow non-possessory security rights in inventory. This is sometimes based upon an alleged inconsistency between the creditor’s security right and the grantor’s right to sell, which is indispensable for converting the inventory to cash with which the grantor will repay a secured loan. Another reason is that the disposition of inventory often gives rise to difficult conflicts between multiple transferees of the encumbered assets or multiple secured creditors. A third reason may arise from a policy decision to reserve inventory for the satisfaction of the claims of the grantor’s unsecured creditors.

101. Varied as the legislation providing for non-possessory security rights may be, it shares one common feature, namely that some form of publicity of the security right is usually required or available. The purpose of publicity, such as that provided by the possession of a pledged asset, is to dispel the false impression of wealth that might arise if the security right in assets held by the grantor is not apparent to third parties. It is often argued, however, that in a modern credit economy, parties should assume that assets may be encumbered by a lender’s security right or may be subject to a seller’s retention of title. For this reason, the argument goes, a general requirement that non-possessory security rights be published is not necessary to protect third parties. Such general assumptions, however, are bound to increase the cost of credit. Even in cases where the person in possession is the owner and the assets are not encumbered, a creditor will not run the risk of there being a hidden encumbrance and will adjust the cost of credit accordingly. Alternatively, the creditor will try to avoid the risk (only partially) through an extensive, time-consuming and costly search. Finally, in systems based on the general assumption that assets will be encumbered and which, consequently, do not have integrated and

fully transparent registries, there is no objective basis for a creditor to know the actual extent to which assets are encumbered and the relative priority of competing security rights. The result is that grantors may not be able to use the full value of their assets to obtain credit.

102. There appears to be a generally recognized need to bridge the gap between the general economic demand for non-possessory security rights and the often-limited access to such security under current law in many States. A major purpose of legal reform in the area of secured transactions is to improve in the field of non-possessory security rights and in the related field of security in intangible property (see sect. A.2 (b) below).

103. While modern regimes demonstrate that difficulties can be overcome, experience shows that legislation on non-possessory security rights requires more effort than simply "modernizing" the traditional possessory pledge. This is due mainly to the following four key characteristics of non-possessory security rights. First, as the grantor retains possession, it has the power to dispose of the encumbered asset or create a competing right in it, even against the secured creditor's will. This situation necessitates the introduction of rules concerning the effects and priority of such dispositions (see chapter VII on priority; A/CN.9/631/Add.4). Second, the secured creditor must ensure that the grantor in possession takes proper care of, duly insures and protects the encumbered assets to preserve their commercial value, matters which must all be addressed in the security agreement between the secured creditor and the grantor (see chapter VIII on rights and obligations of the parties; A/CN.9/631/Add.5). Third, if enforcement of the security right becomes necessary, the secured creditor will usually prefer to obtain the encumbered assets. However, if the grantor is not willing to part with possession of those assets, judicial or extrajudicial proceedings may have to be instituted. Proper remedies, and possibly accelerated enforcement proceedings, may have to be provided for (see chapter X on post-default rights; A/CN.9/631/Add.7). Fourth, the appearance of false wealth in the grantor created by "secret" security rights of third persons in assets held by the grantor, may have to be counteracted by various forms of publicity (see chapter VI on the registry system; A/CN.9/631/Add.3).

104. In the light of the generally recognized economic need for allowing non-possessory security rights and the basic differences discussed above between possessory and non-possessory security rights, new legislation will be necessary in many States taking account of the relative advantages and disadvantages.

105. In view of the legislative models discussed above, legislators may be faced with three options. One option may be to adopt integrated legislation for both possessory and non-possessory security rights (see sect. A.4 below). This is the approach, for example, of the OAS Model Inter-American Law on Secured Transactions, adopted in February 2002. A second option may be to adopt integrated legislation for non-possessory security rights, leaving the regime on possessory security rights to other domestic law. A third approach may be to maintain a fragmented system of different security rights for different types of grantor, different types of asset and different types of security (possessory and non-possessory), but to ensure that all issues relating to third-party effectiveness, priority and enforcement are dealt with under the same set of rules.

106. The prevailing trend in modern legislation, both at the national and the international level, is towards an integrated approach, at least as far as non-possessory security rights are concerned. A selective regulation of specific types of non-possessory security right is likely to result in gaps, overlaps, inconsistencies and lack of transparency, as well as in discontent in those sectors of industry that might be excluded. In addition, such selective regulation makes it more difficult to address conflicts of priority between possessory and non-possessory security rights in States that choose to retain separate regimes for these two types of security right.

(iv) Non-possessory statutory rights

107. Many States do not have an integrated regime governing non-possessory security rights or even an array of specialized regimes for non-possessory security rights. In these States, credit is encouraged through statutes granting particular non-contractual rights to certain categories of creditors. Among the more common beneficiaries of these statutory rights are sellers, suppliers of materials, artisans, tradesmen and repairers. The regimes in question typically do not give the designated creditor a right to exercise special enforcement remedies. The beneficiary of the right must obtain judgement and then seize the property of the debtor in the ordinary way. The sole advantage that the creditor obtains is a priority for payment (or privilege) that may be claimed in the proceeds of the sale in the context of enforcement. Moreover, because the beneficiary of the right normally does not have to publicize its non-possessory statutory right, it is rare that the right can be claimed in property that no longer belongs to the debtor.

108. The existence of these types of statutory non-possessory right does go some way in encouraging the designated beneficiaries to advance credit to their debtors. But they have several disadvantages. They are not available to all types of credit provider. They are secret, in the sense that there is no easy way for other third parties to know of their existence. They do not give creditors access to expeditious enforcement remedies that are likely to generate a higher price upon the sale of the asset. Finally, they provide only a fragile protection to creditors since they cannot be claimed once the debtor no longer owns the property. For all these reasons, the modern trend is for States to cut back on the number of these non-possessory rights and privileges and to expand both the categories of creditors that may contract for a non-possessory security right and the types of asset over which a non-possessory security right may be taken by agreement.

(b) Security rights in intangible property

109. Intangible property comprises a broad variety of rights, such as receivables and intellectual property (for the definitions of “intangible property”, “intellectual property” and “receivable”, see para. 19 above). In view of the dramatic increase in the economic importance of intangible property in recent years, there is a growing demand to use these rights as assets for security. Intangible property (especially in the form of intellectual property) often represents a significant component of the value of other assets, as in the case of inventory and equipment (e.g. goods bearing a valuable trademark and software essential to the operation of equipment). Furthermore, proceeds of inventory or equipment may take the form of intangible property. [Except for certain types of non-intermediated securities,] the Guide does not deal with securities, since they raise a range of issues requiring special treatment

and these issues are addressed in a text being prepared by Unidroit and in the Convention on the Law Applicable to Certain Matters Relating to Securities held with an Intermediary. The Guide does, however, discuss security rights in receivables, as well as security rights in other types of intangible property.

110. By definition, intangible property is incapable of being physically possessed. Nevertheless, codes in many States (including “civil law” States) have dealt with the creation of security rights in intangible property, at least in the case of receivables, by modifying the regime governing the creation of possessory pledges. Some codes have attempted to create the semblance of dispossession by requiring the grantor to transfer any writing or document relating to the pledged receivable (such as the contract from which the receivable is derived) to the creditor. However, such a transfer, in itself, is not sufficient to create the pledge. Rather, the grantor’s “dispossession” is, in many States, symbolized by requiring that a notice of the pledge be given to the debtor of the receivable.

111. In some States, techniques have been developed that achieve ends comparable to those attained by the possession of tangible property. The most radical method is the full transfer of the encumbered right (or the encumbered share of it) to the secured creditor. However, this goes beyond creation of a security right and amounts to a transfer of title, whether conditionally or absolutely (see sect. A.3 (a) below). Under a more restrained approach, title to the encumbered assets is not affected, but dispositions by the grantor that are not authorized by the secured creditor are blocked. In the case of a bank account, if the grantor (the creditor of the encumbered account), as holder of the account, agrees that its account can be blocked in favour of the secured creditor, the latter has the equivalent of possession of tangible property. That is especially the case if the depositary bank itself is the secured creditor.

112. Such techniques of obtaining “possession” of intangible property are sometimes referred to as “control” in modern secured transactions regimes. In general, a secured creditor is deemed to have control of an asset if it has the contractual right to direct the disposition of the asset. For example, in some States a secured creditor may be deemed to have control of the right to payment of funds in a bank account if the depositary bank has contractually bound itself (in a document often referred to as a “control agreement”) to dispose of the funds in the account exclusively at the direction of the secured creditor (for the definition of “control” with respect to a right to payment of funds credited to a bank account, see para. 19 above). The degree of control may vary. In some cases, the control is absolute and any disposition by the grantor is prevented. In other cases, the grantor is allowed to make certain dispositions or dispositions up to a fixed maximum aggregate amount, or until the occurrence of a specified event (sometimes referred to as a “triggering event”).

113. In the context of efforts to create comprehensive regimes for non-possessory security rights in tangible property (see sect. A.2 (a) above), it is common for security rights in one of the most important types of intangible property, receivables, to be integrated into the legal regime applicable to possessory security rights to tangible property. This approach serves consistency, since the sale of inventory results, as a rule, in receivables being generated and it is often desirable to extend the security in inventory to the resulting proceeds. The general registry system used for security in tangible property can perform its salutary functions for

security in intangible property, such as receivables, as well (for details concerning the registry system, see A/CN.9/631/Add.3). This may have the additional benefit of dispensing with the notification of the debtor of the receivable, which in certain secured transactions involving a pool of present and future assets that are not specifically identified may not be practical or feasible. Even if such notification is practical or feasible, it may not be desirable for reasons of confidentiality.

114. In the light of experience with different models for governing security rights in intangible property, new legislation will be necessary in many States. Taking account of the advantages and disadvantages of these approaches, States will face a basic choice. They may either attempt to regulate security rights in intangible property in a regime separate from that governing security rights in tangible property (in which case the technique for generating security will closely resemble a transfer of title) or they may attempt to create an integrated regime that seeks to create a common set of principles governing creation, third-party effectiveness, priority and enforcement of security rights in tangible and intangible property.

115. The predominant tendency in modern legislation is to develop regimes that treat security rights in intangible property under an integrated regime that also governs security rights in tangible property. Such an approach permits grantors and creditors to determine at the outset of their transaction the assets to be encumbered, to establish the relationship between rights in receivables that arise as proceeds and rights that arise when the same receivables are the initially encumbered asset, and to avoid inconsistency and lack of transparency.

3. Use of title for security purposes

116. In many States, alongside various devices and techniques that are intended to function as security rights (see sect. A.2 above), there exists a variety of other legal instruments that can be deployed to generate the equivalent of a security right. Most of these instruments developed through commercial practices, the validity of which was confirmed by courts, but some were either established by or refined through legislation. In so far as creating the equivalent of non-possessory security rights in tangible and intangible property is concerned, the most commonly found alternative instruments and techniques involve the use of title (or ownership) to the asset that is being deployed for security purposes. Title may be used in this way either by the grantor transferring title to the creditor (see sect. A.3 (a) below) or by a creditor (typically a seller or lessor) retaining title to the property that is sold or leased (see sect. A.3 (b) below). Both transfer of title and retention of title enable the creditor to benefit from rights that are equivalent to non-possessory security rights, which, as previously discussed, are essential from an economic standpoint.

(a) Transfer of title

117. Because the various regimes failed to address non-possessory security rights, debtors and creditors looked elsewhere in the law to find principles that could be used to fill gaps or address obstacles to the creation of non-possessory security rights. The transfer of title of the assets to the secured creditor (either conditionally until the loan is repaid or subject to a retransfer to the borrower under a second sale by which the creditor retains title until the loan is repaid) is the most usual technique deployed for this purpose.

118. Today, there are two features that continue to make the security transfer of title attractive for creditors in many States. First, the formal and substantive requirements for transferring title in tangible or intangible property to another person are often less onerous, and therefore less costly, than the requirements for creating a security right. Second, in the case of enforcement, and in the case of the grantor's insolvency, a creditor often has a better position as an owner than as a holder of a security right. This is especially the case where the owner's assets, although in the grantor's possession, are determined to not be part of the insolvency estate, by contrast with the situation where the grantor's assets, if merely encumbered by a security right for the creditor, are deemed to be part of the insolvency estate (see chapter XI on insolvency; A/CN.9/631/Add.8). These two features are not, however, invariably present in national law. For example, in many States the formal difference between title for security purposes and security rights with respect to the requirements for creation or enforcement has been eliminated, to the extent that title devices and security rights are treated the same with respect to their creation. In other States, security transfers are generally subject to the rules applicable to transfers of title while, in the case of enforcement and insolvency, they are treated as security devices.

119. The security transfer of title has been established by law in some States (usually under regimes dealing with sales with a right to reclaim or repurchase) and by practice and courts in other States. Today, there is a variety of approaches that States take to the transfer of title for security purposes. As noted, in some States, its creation is subject to the less demanding rules governing transfers of title and it has the effect of a full transfer of title. In other States, its creation is subject to the more cumbersome rules governing security rights and it has only the effect of a secured transaction. In yet other States, especially from the civil law world, many if not all such transfers of title are regarded as a circumvention of the ordinary regime of security instruments and are, therefore, held to be null and void. In States that have adopted a comprehensive and integrated regime for non-possessory security rights, transfer of title for security purposes is available but is treated as a security device. In these States, the creation, third-party effectiveness, priority and enforcement of a transfer of title for security purposes are subject to the same requirements applicable to security rights (see sect. A.4 below).

120. With respect to the treatment of transfers of title for security purposes, legislators are faced with two policy options. One option is to admit security transfers of title with the (usually) reduced requirements and the greater effects of a full transfer, thus avoiding the general regime for security rights. This option results in enhancing the secured creditor's position (although at the risk of increasing the liability of the creditor; see chapter IV on creation of a security right, para. 200 below), while weakening the position of the grantor and the grantor's other creditors.

121. The other option is to allow security transfers of title, but to limit either the requirements or the effects or both to those of a mere security right. This can be done in one of two ways. On the one hand, States could specify the transfer-of-title transactions that will be permitted, prohibiting all others, and subject these permitted devices to the creation, third-party effectiveness, priority and enforcement regime applicable to security rights. Some civil law States have taken this approach. On the other hand, States could simply provide that these security transfer-of-title

transactions will be characterized as security rights. Many common law States have taken this approach. Under both these alternatives, a graduated reduction of the secured creditor's advantages and of the other parties' corresponding disadvantages is possible, especially if the requirements of a transfer of title or its effects, or both, are limited to those relating to a security right. The second alternative is the approach followed in States with an integrated, comprehensive secured transactions regime, and is also the approach recommended by this Guide (see A/CN.9/631, recommendation 11).

(b) Retention of title

122. The second method of using title as security is effected by techniques that permit sellers to use their title to tangible property being sold to a buyer as a means to secure payment of the purchase price. The most common, but not exclusive, means for doing so is through a contractual retention-of-title (reservation-of-ownership) arrangement. Nonetheless, there are several other mechanisms by which sellers may deploy title, some arising by statute and others arising by agreement between the parties.

123. In many States, the law of sale permits creditors that have actually transferred title to the buyer to seek the annulment of the sale if the buyer does not pay the price. Upon annulment, the seller may then reclaim ownership and possession of the property free and clear of any encumbrances that the buyer may have created in it. These reclamation rights typically arise by operation of law, although in some States sellers are able to extend the reclamation right by contract beyond that provided in the law of sale. As this Guide focuses on security rights created by agreement, these statutory seller's remedies will not be discussed further here (for a more complete discussion, see chapter XII on acquisition financing rights; A/CN.9/631/Add.9).

124. In a simple retention-of-title arrangement, the seller may retain title to the goods sold until full payment of the purchase price for those goods. Lenders may also participate in such financings by accepting an assignment of the secured obligation from the seller. There are several variations on retention-of-title transactions. Sometimes, the seller merely promises to sell the property to the buyer and the sale (and transfer of title) is completed only upon full payment. Sometimes, the sale is made conditional upon the purchaser paying the full price. Most often, however, the sale is immediate, and it is only the transfer of title that is made conditional upon the buyer paying the price. The common thread to all these variations is that, even though the buyer may have possession and the use of the property (and in some cases may even have the right to dispose of the property), it does not actually obtain rights in the property until the purchase price is fully paid. Until that moment, title continues to vest in the seller.

125. States also permit variations in the scope of retention-of-title agreements. Sometimes these relate to the obligation secured and sometimes to the property that is subject to the retention of title. For example, in an "all-monies" or "current-account" retention-of-title arrangement, the seller retains title to the goods sold until all obligations owed by the buyer have been discharged, whether such obligations relate to those goods or to other goods purchased by that buyer from the seller. In an "extended" retention-of-title arrangement, the seller's rights may also extend to receivables or other proceeds arising upon the sale of the goods. However, such an arrangement exists in very few States. In any case, even in those States, the right to

the proceeds generally is extinguished when the proceeds are commingled with other proceeds. In the vast majority of States, retention of title does not extend to proceeds. Also, in almost all States, retention of title extends to goods only while they retain their identity and the right is extinguished once the goods are incorporated into other goods in the manufacturing process, or otherwise lose their original identity.

126. An alternative to a retention-of-title arrangement, but with the same economic result, can be achieved by combining a lease contract with an option of the lessee to purchase the leased object at a nominal price, which may only be exercised after the lessee has paid most of the notional "purchase price" through rent instalments (see the example given in chapter II, section C.1, para. 62 above). In some cases, where the lease covers the full useful life of the leased equipment, it is equivalent to a retention-of-title arrangement even without an option to buy. These variations are all intended to function as devices to enable a borrower to finance the "acquisition" of either equipment or inventory (see chapter XII on acquisition financing rights; A/CN.9/631/Add.9). In the following paragraphs, at least with respect to leases that serve a security function, the term "seller" includes the term "lessor", and the term "buyer" includes the term "lessee".

127. Economically, a retention-of-title arrangement provides a security right that is particularly well adapted to the needs of sellers in securing credit extended for the purchase price of goods. In many States, this kind of credit, which is typically made available by suppliers, is widely used as an alternative to general bank financing and is given preferential status in view of the importance for the economy of small- and medium-sized suppliers of goods. In other States, banks also provide acquisition financing on a more regular basis and, as a result, have developed practices that enable them to take advantage of the retention-of-title mechanism. For example, a seller can sell goods to a bank for cash and the bank then can resell the goods to the buyer on credit under a retention-of-title arrangement; or a buyer might pay the seller in cash from a loan and then transfer title to the bank as security for the loan. In those States, this source of credit and its attendant specific security is often accorded a special privilege in the form of a heightened priority over conflicting security rights in the same goods, provided that certain formal requirements are complied with.

128. Due to its origin as a term of a contract of sale or lease, many States (including a number of States that treat security transfer-of-title devices as the equivalent of security devices) still regard the retention-of-title arrangement as a mere quasi-security. As a result, they do not subject retention-of-title devices to the general rules applicable to security rights, notably as to form for creation, method of third-party effectiveness, priority and enforcement. Further advantages are that it can be created in a cost-effective way since, in many States, it is not subject to publicity. Retention of title is also well suited to short-term financing and, in some States, it gives rise to a proprietary right of the buyer. In States that permit the creation of non-possessory security rights only in certain types of asset, but not in inventory, retention of title is used for inventory financing. Another advantage is that the seller retaining title has, in many States, a privileged status. This may be justified by the desire to support normally small- and medium-sized suppliers and to promote acquisition financing by suppliers as an alternative to general bank credit.

129. At the same time, retention-of-title arrangements present certain disadvantages. The position of the buyer and the buyer's creditors is weakened and, in the absence of publicity, third parties have to rely on the buyer's representations or take the time and incur the cost to collect information from other sources. Another disadvantage is that it may prevent, or at least impede, the buyer from using the purchased assets for granting a second-ranking security to another creditor. Yet another disadvantage is that enforcement by the buyer's other creditors is impossible or difficult without the seller's consent. For these reasons, in some States retention-of-title arrangements are treated in the same way as security rights in every respect, while, in other States, they are treated as security rights in some but not in all respects (e.g. they are subject to publicity but are given a special priority status). In yet other States, retention-of-title arrangements are ineffective as against third parties in general or only if they relate to certain assets, especially inventory, on the theory that the seller's retention of title is incompatible with the seller granting to the buyer the right and power of disposition over the inventory.

130. Several policy options may be considered by States. One option is to preserve the special character of retention of title as a title device. Under this approach, retention of title would not be subject to any requirements as to form or publicity. Another, slightly different, option would be to preserve the special character of retention of title but to limit its effects to securing only the purchase price of the affected asset to the exclusion of any other credit; and to restrict it to the purchased asset to the exclusion of proceeds or products. A third option is to integrate retention-of-title arrangements into the ordinary system of security rights. In such a case, the creation, third-party effectiveness, priority and enforcement, even in the buyer's insolvency, of a retention-of-title arrangement would be subject to the same rules applicable to security rights. Under such an approach, for the policy reasons mentioned above, it would be possible to grant the seller certain advantages (e.g. priority as of the time of the conclusion of the sales contract in which the retention of title was contained or as of the time of delivery of the goods). A fourth option might be to keep the retention of title as a separate transaction, but to place it on a par with any other security right (i.e. without granting the retention-of-title seller any special privileges relating to creation, third-party effectiveness, priority and enforcement). These options are discussed in greater detail in chapter XII on acquisition financing rights (see A/CN.9/631/Add.9).

4. Integrated and functional approach to security

131. Throughout the twentieth century, the credit demands of business were often frustrated by the lack of a suitable legal framework through which borrowers could grant security rights to lenders and other credit providers. Sometimes, the law explicitly prohibited the granting of security over certain types of asset. Sometimes, an appropriate legal device simply did not exist. Sometimes, parties were able to cobble together a legal device to serve their purposes, but it was inefficient, costly and complex to operate. These problems were at the source of many of the developments just reviewed. For example, they led to contractual practices and legislative innovations permitting fictitious "pledges" and the creation of specialized legal transactions meant to solve problems created in particular sectors of economic activity; they also stimulated the development of a variety of transfer-of-title mechanisms; and they lay behind both the extensive deployment of retention-of-title agreements and the different variations on retention of title

intended to increase its efficiency as a legal device for securing the performance of an obligation.

132. Faced with the complexity, inefficiency and gaps created by this ad hoc approach to adjusting legal regimes to meet the credit needs of business, by the middle of the twentieth century some States decided to rethink the whole field of security rights in movable property. The creation of a single, integrated, comprehensive and functionally defined security right in all types of movable property was the result of this reflection. This approach to security rights was inspired by the observation that the many different types of non-possessory security right, the traditional possessory pledge and the several variations on title-transfer and retention-of-title devices were all based upon a few identical guiding principles that aimed at achieving the same functional outcomes.

133. The main theme in this new approach to security rights is that substance must prevail over form. It is no accident that this idea first developed in federal States, such as the United States of America and Canada. The United States Uniform Commercial Code, a model law now adopted by all 50 states (including the mixed common law and civil law state of Louisiana), created a single, comprehensive security right in movable property unifying numerous and diverse possessory and non-possessory rights in tangible property and intangible property, including transfer- and retention-of-title arrangements, that existed under state statutes and common law. The idea spread to Canada (including the civil law jurisdiction of Quebec), New Zealand, India and various other States (many of which are civil law jurisdictions in Central and Eastern Europe). The OAS Inter-American Model Law on Secured Transactions follows a similar approach in many respects. The EBRD Model Law on Secured Transactions follows a similar approach to the extent that it creates a specific "security interest" which can work side by side with other security devices (e.g. leasing) and re-characterizes retention of title as a security right.

134. As an approach to creating an efficient regime that enhances the provision of low-cost credit to businesses and consumers, an integrated comprehensive security system presents certain important advantages.

135. First, all relevant statutes dealing with non-possessory security rights (which are often great in number) may be merged into one text, an approach that ensures comprehensiveness, consistency and transparency of the rules. Second, the rules on possessory security rights, especially the possessory pledge, may be covered and at the same time adapted to contemporary requirements (e.g. by introducing the notion of control in relation to security rights in intangible property). Third, title devices, such as security transfer and retention of title, may be integrated into the system in a way that not only gives sellers the protection they desire, but also enables buyers to use whatever value they have acquired in property purchased to obtain additional credit. Fourth, contractual arrangements that fulfil a security function, such as leasing contracts, sale and resale, may also be included and covered in a way that minimizes conflict and confusion about the priority of the rights of different creditors.

136. In addition, under this approach, a creditor that envisages granting a secured loan need not investigate various alternative security devices and evaluate their respective prerequisites and limits as well as advantages and disadvantages. Correspondingly, the burden borne by the grantor's creditors, or the insolvency

representative for the grantor that must consider their rights (and duties) vis-à-vis the secured creditor, is lessened if only one regime, characterized by a comprehensive security right, has to be examined rather than several different regimes. Further, this will reduce the cost of creating security rights and, concomitantly, the cost of secured credit.

137. In cross-border situations, the recognition of security rights created in assets in one State that are then moved to another State will also be facilitated if the State into which the assets are moved recognizes a comprehensive security right. Such a system can much more easily accept a broad variety of foreign security rights, whether of a narrow or an equally comprehensive character.

138. There are, however, some disadvantages to the integrated, comprehensive approach. First, this approach may require re-characterization of certain transactions (e.g. transfer of title for security purposes or retention of title), at least for the purpose of secured transactions laws. For States that do not already accept the "relativity of title" to movable property, it will be necessary to have an extensive re-education for lawyers and business people as to how such a re-characterization would operate in practice. In addition, this approach requires adjusting the basic legal logic that has heretofore underpinned the law relating to security rights in many States. In these States, security rights are conceived to be exceptions to the general principle of equality of creditors and must therefore be restrictively interpreted. Moreover, security is usually conceived as a specific right, over specific assets, to secure a specific obligation, owed by a specific debtor to a specific creditor. The integrated and comprehensive approach presumes that these traditional limitations will be displaced by a general principle favouring the spread of secured credit. Finally, this approach normally assumes that the new regime will be brought into force in a single piece of legislation. For some States this will involve significant adjustment to the manner in which their civil codes, commercial codes or other statutes are organized.

139. Many of these disadvantages can be reduced or eliminated by careful attention to the manner in which a State chooses to develop legislation creating an integrated and comprehensive security right. For example, it would be possible to achieve most of the advantages while avoiding most of the disadvantages through (a) a comprehensive reform of existing laws relating to security rights, title devices serving security purposes, the assignment of receivables and financial leases; and (b) the enactment of specific statutory rules to regulate contractual practices that have been developed to overcome gaps in the law. In any case, the effort required to do so in a manner that would achieve consistency, transparency, efficiency and the establishment of genuine competition among all providers of credit on the basis of price would be considerable.

140. If a State were to adopt an approach that favoured the enactment of a comprehensive, integrated regime, technically either of two different approaches could be used. Under one approach, the names of the old security devices, such as pledge, floating charge, transfer of title for security purposes and retention of title, would be preserved and used. However, their creation and effects as security rights would be made subject to an integrated set of rules, even though they would continue to have their full title effects for other purposes (e.g., taxation or accounting). Under a slightly different approach, all types of rights serving security purposes would be subsumed into a unitary notion of security right and the rules

applicable to certain basic types of contract that may be used for purposes of security, such as sales, leases or assignments, would be supplemented by certain specified additional rules (e.g. with respect to third-party effectiveness, priority and enforcement).

141. The Guide recommends the establishment of an integrated, comprehensive secured transactions regime as the approach that will most effectively promote secured credit. In principle, it also recommends that States adopt the second of the two techniques just presented for doing so (an approach that may be described as a functional and unitary approach). However, the Guide also recognizes that some States may not be in a position to adopt the functional and unitary approach to acquisition financing rights and therefore contemplates that, in this particular situation, States might choose to adopt the first approach to achieving a comprehensive and integrated regime, an approach that might be characterized as a functional and non-unitary approach (for a more detailed discussion, see chapter XII on acquisition financing rights; A/CN.9/631/Add.9).

B. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.*]

IV. Creation of a security right (effectiveness as between the parties)

A. General remarks

1. Introduction

142. A security right under the Guide is a property right (as opposed to a personal right) in movable property (as opposed to immovable property) created by agreement (as opposed to statutory or judgement rights) between the grantor and the secured creditor that is meant to secure the performance of an obligation owed by the grantor or another person to that creditor (for the definition of “security right”, see para. 19 above). A key issue, therefore, is to determine the steps necessary for a security right to become fully effective between the parties and as against third parties.

143. In some States, a fully effective security right in an asset only comes into being upon conclusion of a security agreement and completion of an additional act, such as delivery of possession of the encumbered asset. Depending on the nature of the asset, notification of a third party may be required (as in the case of receivables) or registration (as in the case of ships or aircraft). Until these acts have occurred, the security right is not considered as having been created and is not, therefore effective, even as between the parties. However, once these acts have occurred, the security right is effective not only as between the parties, but also as against any

person whether party to the security agreement or not (this is often referred to as the *erga omnes* effect of property rights).

144. In other States, a distinction is made between the effectiveness of a security right as between the parties (*inter partes*) and its effectiveness as against third parties. The security right comes into existence upon conclusion of the security agreement, but is effective only as between the parties. An additional act is required for the security right to become effective against third parties. This additional act also serves as a basis for determining the priority of the security right as against competing claimants (for the definitions of "competing claimant" and "priority", see para. 19 above). The main advantage of this approach is practical, making it possible for a grantor to offer the same assets as security to more than one creditor (thereby increasing the amount of credit that a grantor can obtain based upon the value of the assets), while creating a basis for determining the priority ranking of those creditors.

145. This approach is based on the idea that a security right has two distinct elements. There is, first, a relationship between the parties; and there is, second, a property element to the security that will produce effects that directly affect the rights of third parties. In other words, the security agreement is sufficient for the security right to be effective as between the parties, but insufficient to establish effectiveness against third parties, such as other secured creditors, judgement creditors or the insolvency representative in the insolvency of the grantor. Furthermore, this approach is based on the assumption that there is no need to subject effectiveness as between the parties to notification or registration and, to the contrary, such an approach could create an obstacle to transactions that serve security purposes but are based on informal sale or lease techniques (e.g. retention-of-title sales, financial leases or hire-purchase agreements).

146. Some States adopt a third approach, which is a hybrid between the first two approaches. It involves treating a security right as effective against all upon its creation (including the grantor's unsecured creditors, judgement creditors, the grantor's insolvency representative, donees and transferees of encumbered assets outside the ordinary course of business of the grantor), but provides for the application of special rules of third-party effectiveness and priority in the case of competing claimants that assert specific rights in the encumbered assets (e.g. competing secured creditors or transferees of encumbered assets in the ordinary course of business). This approach generally leads to the same results as the second approach, with a slight variation in relation to the rights of certain creditors, such as unsecured creditors, judgement creditors and the insolvency representative (see A/CN.9/631/Add.2, paras. […]).

147. This Guide adopts the second of the three general approaches to creation and effectiveness of security rights just reviewed. That is, it recommends an approach that distinguishes between the requirements necessary for a security right to be effective as between the parties and those necessary for parties to achieve third-party effectiveness of the security right (see paras. 144 and 145 above). This chapter deals with issues relating to the creation of a security right in an asset by agreement and its effectiveness as between the parties to the security agreement. The effectiveness of a security right against third parties is discussed in chapter V on effectiveness against third parties (see A/CN.9/631/Add.2). The rules for the priority ranking of creditors with claims in the same assets are discussed in chapter VII on

priority (see A/CN.9/631/Add.4). Matters related to the effectiveness of a security right in the case of insolvency are discussed in chapter XI on insolvency (see A/CN.9/631/Add.8).

2. Creation of a security right

148. Two separate issues must be addressed in a consideration of the creation of a security right and its effectiveness as between the grantor and the secured creditor. Most importantly, there is the question of creation, that is, when and under what conditions a security right is created. There is also the question of effectiveness as between the parties generally, that is, when and under what conditions a security right becomes effective between the parties. Normally these two questions have the same answer. When the steps for creation of a security right have been accomplished, it becomes effective as between the parties at that moment. However, it may be that a security right that has been created later ceases to be effective as between the parties. In such cases, it is important to determine exactly when the right has ceased to be effective even as between the parties. These two facets of the question are considered in turn.

149. In most States, the creation of a security right in movable property requires that an agreement (for the definition of "security agreement", see para. 19 above) between the grantor and the secured creditor providing for such creation be concluded (see A/CN.9/631, recommendation 12).

150. The security agreement may fulfil several functions, including (a) providing the legal basis for granting a security right; (b) establishing the connection between the security right and the obligation it secures; (c) generally regulating the relationship between the grantor and the secured creditor (for pre-default rights, see chapter VIII; A/CN.9/631/Add.5); and (d) minimizing the risk of disputes with respect to the contents of the security agreement and the risk of manipulation after default (for post-default rights, see chapter X, A/CN.9/631/Add.7).

151. While the security agreement sometimes may be a separate agreement between the parties, often it is contained in the underlying financing contract or other similar contract between the grantor and the secured creditor, such as a contract for the sale of goods on credit.

152. As previously noted, in many States, the security agreement is itself sufficient to create the security right as between the grantor and the secured creditor. In other States, however, in addition to the security agreement, another act is required for a security right to be created even as between the parties (i.e. transfer of possession, notification or registration). What that act might be varies from State to State, and even within individual States, according to the type of security right or asset involved.

153. Certain agreements relating to title to movable property may serve security purposes. These include, for example, a seller's retention of title, transfer of title for security purposes, assignment of receivables for security purposes, as well as sale and resale, sale and leaseback and hire-purchase and financial lease (for the definitions of "assignment", "financial lease" and "retention-of-title right", see para. 19 above).

154. In legal systems with a comprehensive and integrated secured transactions regime, title-based devices that serve security purposes are generally required to be created in the same way as any other security right. They are either replaced by a uniform notion of security right or, while their various terms are preserved, the specific requirements necessary for their creation as between the parties are the same as those applicable to security rights

155. In other legal systems, title-based devices are the main mechanism by which non-possessory security rights may be created. In such States, title devices are usually regulated according to the rules applicable to the specific transaction by which title is meant to pass between the parties (e.g. a sale, an exchange, a lease with option to purchase and so on). Sometimes, given their function as security, these transactional rules are also overlain with various statutory and court developed rules. The detail of the regimes in legal systems that preserve the specificity of title devices can differ widely from State to State. In some legal systems, only retention of title is subject to a specific regime, while transfer of title for security purposes from a borrower to a lender and the assignment of receivables for security purposes are subject to the same rules governing the creation of security rights. In other legal systems, some transfer of title devices, such as a sale with a right of redemption, are also subjected to a specific regime in the same manner as retention-of-title devices.

156. The treatment of retention-of-title devices is a key indicator of how a legal system generally conceives of title-based security. Legal systems that do not treat title-based devices as constituting security rights usually place particular emphasis on retention of title, even though they can have quite different requirements for the creation of retention-of-title devices. That is, in these systems, retention of title is used widely and is effective as against all parties. In other legal systems, however, retention of title plays an insignificant role and is generally ineffective, or at least ineffective as against the insolvency representative in the buyer's insolvency. One point on which many legal systems converge is that only simple retention-of-title agreements are treated as a genuine title device, while agreements that contain all-sums clauses or proceeds and products clauses are treated as true security devices. Another point on which many legal systems converge is that only the seller may retain title. Other suppliers of credit may benefit from a retention of title only if they receive an assignment of the outstanding balance of the purchase price from the seller (see chapter XII on acquisition financing rights; A/CN.9/631/Add.9).

157. In most legal systems that recognize retention of title, the seller's rights derive from a clause in the sale agreement. In a few States, retention of title is presumed in all sales on credit and the seller's retention right need not even be explicitly stated in the sale agreement. In other States, the contractual right of retention may be concluded between the parties even orally or by reference to printed general terms in a supply document or invoice. In still other legal systems, some type of writing, a certain date for the agreement and even registration may be required.

158. Legal systems also differ substantially in the terminology used and the requirements for transfers of title for security purposes. For example, these can be called fiduciary transfers of title for security purposes, sales with a right to reclaim, double sales and sale-leaseback with an option to purchase. A first point to note is that, in some legal systems, a security transfer of title is void as against third parties, and occasionally even as between the transferor and the transferee. In other legal systems, while a security transfer of title is effective, it is not widely used in view of

the existence of other non-possessory security rights. In most of the legal systems that recognize the security transfer of title, the rules with respect to its creation are the same as those applicable to secured transactions in general or at least in the case of the transferor's insolvency. So, for example, a sale with a right to reclaim or a double sale will usually be with respect to the form and content of the agreement subject to the same rules as those applicable to secured transactions.

159. Many legal systems also recognize that transactions built around the idea of a lease (hire-purchase and financial lease in the context of acquisition financing and sale-leaseback in the context of a lending transaction) often perform security functions. In some legal systems, they are treated as security devices and the requirements for their creation and effectiveness as between the parties are those applicable to all other security devices. In other legal systems, they are treated not as security devices but as contractual arrangements creating personal rights. In these legal systems, the requirements for their creation will normally be those applicable to the creation of a contractual right of that type as between the parties.

160. The second issue that States face when deciding the basic requirements for the creation of a security right is to determine when the security right actually becomes effective between the parties. In most States, because the security right arises from an agreement between the parties, it becomes effective between them as soon as it is concluded. The parties may, of course, agree to defer the effectiveness of the security right to a later time, but normally do not do so (in any case, they cannot agree to a time earlier than the time of the conclusion of the agreement). It is also necessary to determine when the security right begins to affect the assets that are encumbered. Here a distinction must be drawn between present assets of the grantor and future assets. Where the security agreement provides for the creation of a security right in assets with respect to which the grantor has rights, or the power to encumber, at the time the security agreement is concluded, the security right is effective between the parties in relation to those assets as of that time, subject to any agreement between the parties to defer effectiveness in respect of some or all those assets. Where, however, the security agreement provides for the creation of a security right in assets with respect to which the grantor expects to acquire rights, or the power to encumber, in the future, the security right is effective between the parties in relation to those assets only from the time the grantor acquires such rights or the right to encumber, unless of course, the parties agree to postpone the date of effectiveness (see A/CN.9/631, recommendation 12; see also para. 185 below).

3. Essential elements of a security agreement

161. Legal systems differ as to the essential elements that a security agreement must contain in order to be effective between the parties. Certain elements are, however, common to most legal systems. Typically, States require that the security agreement must (a) identify the parties; (b) state the obligation to be secured; and (c) describe the assets to be encumbered. Some States also impose a requirement that the security agreement set out the maximum amount for which the security right may be claimed in the encumbered assets.

162. The degree of specificity required for identification of the secured obligation and the encumbered assets varies from State to State. The advantage of a specific description is certainty, but the disadvantage is inflexibility to address important financing transactions involving changing amounts of secured obligations and a

changing pool of encumbered assets, including after-acquired assets (such as, for example, revolving credit facilities relating to inventory or receivables). In any case, whether or not legislation lists the identification of the parties and the description of the obligation to be secured and the assets to be encumbered as the minimum contents of a security agreement, failure to deal with them in the security agreement may result in disputes concerning the scope of the assets encumbered and the obligation secured, unless the missing elements may be established through other means.

163. The parties to the security agreement may also use it to clarify additional matters, such as the duty of care on the part of the party in possession of the encumbered assets and representations with respect to the encumbered assets. In the absence of an agreement, default rules may apply to clarify the relationship between the parties (for pre-default issues, see chapter VIII, A/CN.9/631/Add.5; for post-default issues, see chapter X, A/CN.9/631/Add.7).

164. Many modern secured transactions regimes refrain from adopting elaborate requirements for the effectiveness of a security agreement and instead reflect the view that the promotion of secured credit is facilitated by providing that an agreement may be effective if it meets certain minimal requirements, such as (a) reflecting the intent of the parties to create a security right; (b) identifying the parties (e.g. the grantor and secured creditor); (c) describing the obligation to be secured by the security right; and (d) describing the assets to be encumbered (see A/CN.9/631, recommendation 13).

165. As more fully discussed below (see paras. 188-190), the Guide takes the position that a generic description of the encumbered assets is sufficient, such as “all present and future assets” or “all present and future inventory”.

4. Form of a security agreement

166. Legal systems also take different positions as to the form requirements for security agreements and the function of these requirements. In particular, some legal systems do not require that there be a written security agreement, while other legal systems require some kind of writing. In a few States, a simple, unsigned writing is sufficient. In other States, a signed writing is required. In yet other States, the security agreement must be in a notarized writing or an equivalent document. Normally, written form performs the function of a warning to the parties of the legal consequences of their agreement, of evidence of the agreement and, in the case of authenticated documents, of protection for third parties against fraudulent antedating of the security agreement. Written form may also serve other purposes besides being a condition of effectiveness as between the parties. For example, in many States it is a condition of effectiveness as against third parties, or of priority among competing claimants. In many of these States, written form may also be a condition for obtaining possession of the encumbered assets or for invoking the security agreement in the case of enforcement, within or outside insolvency.

167. In some legal systems, a certification of the date by a public authority is required for possessory security rights, with the exception of small-amount loans where proof by way of witnesses is permitted. While such certification may address the problem of fraudulent antedating, it may raise a problem with respect to the time and cost required for a transaction. In other legal systems, a certified date or

authentication of the security agreement is required for various types of non-possessory security (see, for example, articles 65, 70, 94 and 101 of the Uniform Act Organizing Securities of the Organization for Harmonization of Business Law in Africa). In some of those systems, such certification is required instead of registration. Where, however, registration is necessary, an additional certification of the date of the security agreement is not required.

168. In many legal systems, in the interest of saving time and cost, mandatory form requirements are kept to a minimum. A simple writing (including, for example, general terms and conditions on an invoice) is sufficient as long as it, either alone or in conjunction with the course of conduct of the parties, indicates the intention of the grantor to grant a security right. Consistent with the idea of simplifying as much as possible the process for creating a security right, which is one of the key objectives of the Guide (see para. 23 above), this is the position of the Guide (see A/CN.9/631, recommendations 1, subpara. (c), and 14). Writing includes an electronic communication (see A/CN.9/631, recommendation 9). The one exception to the above rules is that the security agreement may be oral if accompanied by a transfer of possession of the encumbered asset to the secured creditor (see A/CN.9/631, recommendation 14). However, if the security right is created by oral agreement and transfer of possession, and later the secured creditor relinquishes possession, a written agreement is necessary for the security right to continue to exist.

[*Note to the Commission: The Commission may wish to consider revising recommendation 14 to clarify that, if the secured creditor relinquishes possession of an encumbered asset in which a security right was created by oral agreement and transfer of possession, a written agreement is necessary for the security right to continue to exist.*]

169. The security agreement is typically concluded between the debtor as grantor of the security right and the secured creditor. Occasionally, if a third person grants the security for the benefit of the debtor, this person becomes a party to the agreement instead of, or in addition to, the debtor. In the case of large loans granted collectively by several lenders (especially in the case of syndicated loans), a third party, acting as agent or trustee for the lenders, may hold security rights on behalf of all of the lenders. Security agreements may be tailored to cover each of these situations. While some systems introduce limitations (e.g. only enterprises may grant an enterprise mortgage), in other systems both natural and legal persons may be parties to a security agreement.

5. Obligations subject to a security agreement

170. Security rights are accessory to, and dependent upon, the obligation they secure. This means that the validity and the terms of the security agreement depend on the validity and the terms of the agreement establishing the secured obligation. In particular, with respect to revolving loan transactions a security right is accessory in the sense that, while it can secure future advances and fluctuating obligations, it cannot be enforced if there is no advance on the loan and cannot surpass the amount of the obligation owed at the time of enforcement.

171. In some States, non-possessory security rights may relate only to specific types of obligation described in legislation (e.g. loans for the purchase of

automobiles or loans to farmers). In other States with a general regime for possessory security rights only or for both possessory and non-possessory security rights, no such limitations exist. Such a comprehensive approach (see A/CN.9/631, recommendation 15) has the potential of spreading the main benefits derived from secured financing (i.e. greater availability and lower cost of credit) to a wide range of transactions. In addition, such an approach enhances consistency and equal treatment of all debtors and secured creditors. To the extent such special regimes are necessary for specific socio-economic reasons, adverse effects may be minimized if such regimes are established in a clear and transparent way and are limited to a narrow range of transactions.

172. States that do not link certain forms of security to certain types of obligation typically do not limit the types of obligation for which a security right may be granted. Moreover, unless there is a special regime for security rights in specific types of obligation (e.g. for loans by pawnbrokers), States usually do it to list in legislation all the types of obligation that can be secured. Given the pace at which new types of credit obligations are being created, it would be impossible to enact an exhaustive list that would not quickly be out of date. It is, however, common for States to provide an indicative list. Such a list would typically include obligations arising from loans and the purchase of goods, including inventory and equipment, on credit.

173. Legal systems take different positions on whether, and to what extent, a security agreement may be created to secure future obligations. They also differ on the definition of what a future obligation actually is. In some systems, future obligations are the obligations that have not been contracted for (this is the approach of the United Nations Assignment Convention; see article 5, subpara. (b)). In other systems, even obligations that have been contracted for but are not due at the time of the security agreement (because the loan has not yet been advanced or the loan involves a revolving loan facility) are treated as future obligations. In addition, obligations subject to a condition subsequent are invariably treated as present obligations, while obligations subject to a condition precedent are normally treated as future obligations.

174. The distinction between present and future obligations is significant in those legal systems in which, for reasons of certainty and debtor protection, future obligations may not be capable of being secured or may be secured only up to a maximum amount, or may not be secured if they are indeterminate (e.g. where the security agreement purports to cover “all present and future obligations of whatever type that may arise between the parties”). In States that impose limits on granting security rights to secure future obligations, debtors may not be able to benefit from certain transactions, such as revolving loan facilities or convertible term loans. In other legal systems, future obligations may be freely secured. In these systems, one security agreement is sufficient to cover both present and future obligations. As a result, each extension or increase of credit does not require that the corresponding security right be modified or even newly created, and this has a positive impact on the availability and the cost of credit. While a security right may be created in a future obligation, it cannot be enforced until the obligation arises and becomes due. Some States impose various requirements as to the manner in which the type and amount of the secured obligation may be stated.

175. In some legal systems, it is necessary for the parties to describe the secured obligations in their agreement in specific terms to set a maximum limit to the amount for which the asset can be encumbered as security for the secured obligation, or even to reduce the amount of the security to reflect the current balance owed on that obligation. The assumption is that such a description or limit is in the interest of the debtor since the debtor would be protected from over-indebtedness and would have the option of obtaining additional credit from another party. However, such requirements may result in limiting the amount of credit available from the initial creditor or may lead creditors to indicate an amount well in excess of the actual amount that they agree to advance to the grantor. The result often is, consequently, that the grantor is deprived of the ability to use the full value of its assets to secure either additional obligations to its present creditor or new obligations contracted with other creditors.

176. Modern financing transactions often no longer involve a one-time payment but instead frequently foresee advances being made at different points of time depending on the needs of the grantor (for example, revolving credit facilities for the grantor to buy inventory). Such financing may be conducted on the basis of a current account, the balance of which fluctuates daily. If the amount of the secured obligation were to be reduced by each payment made, lenders would be discouraged from making further advances unless they were granted additional security. This would be highly inefficient as it would add to the cost and the time necessary for the grantor to acquire new goods required for the conduct of its business. Finally, a few States attempt to control credit by imposing limits on the amount for which an asset may be encumbered, calculated as a percentage of the credit advanced to the grantor (e.g. 125 per cent of the obligation owed). These types of legislative limit as to the amount to be secured are unavoidably arbitrary, usually cannot be fine-tuned to meet the credit needs of individual grantors and would normally need to be adjusted constantly to reflect changes in the credit relationship between the grantor and the secured creditor.

177. For all of the above reasons, many legal systems do not require specific descriptions of the secured obligations and allow parties to negotiate freely the amount to be secured, including all sums owed by the debtor to the secured creditor. In those legal systems, the secured obligation must be determined or determinable on the basis of the security agreement whenever a determination is needed (as is the case, for example, when the secured creditor enforces its security rights). Moreover, the grantor is protected because the secured creditor cannot claim from the encumbered assets more than it is owed and, if the obligation is fully secured, better credit terms are likely to be offered to the grantor by the secured creditor.

178. States also take different positions as to whether the actual amount of the secured obligation (including the rate of interest, if any) must be stated in the security agreement itself and whether that amount must be expressed in a currency and, if so, in what currency it must be expressed. For example, some States require that the security agreement indicate not only the type of obligation being secured but also its amount (e.g. the actual amount of the credit being provided). Other States require only that the type of obligation be stated and leave the details to the loan or credit agreement. In addition some States require the obligation to be expressed in a currency, while others permit the parties to express the repayment obligation however they wish. Today, many States do not impose any restrictions on

the currency in which the amount of the secured obligation may be expressed beyond those applicable to obligations generally.

179. Where there is debtor default (or insolvency) and disposition of the encumbered assets, the proceeds may be paid in a currency (for example, dollars) different from the currency (for example, euros) in which the secured obligation is expressed. In such cases, it will be necessary to convert the proceeds from the disposition of the encumbered assets so that the secured obligation and the encumbered assets are expressed in the same currency. This issue, however, is typically left to the contract from which the secured obligation arises and to the applicable law (e.g. in the absence of an agreement, the exchange rate prevailing at the place of enforcement or insolvency proceedings will prevail).

6. Assets subject to a security agreement

180. A central aspect of the security agreement is the identification of the assets that will be subject to the security right. States typically are required to address four separate issues when determining how the assets that may be subject to the security right should be identified. First is the question of whether security may be granted in property not owned, or not yet owned, by the grantor. Second is the question of whether certain types of asset should not be susceptible of encumbrance by a security right. Third is the question as to how the assets may be described (i.e. whether they must be described individually or they may be described generically). Finally, States have to decide whether a grantor should be permitted to create a security right that generally covers all its assets (i.e. an agreement that in many States takes the form of an "enterprise mortgage").

(a) Future assets

181. In most legal systems, the grantor of the security has to be the owner of the assets to be encumbered or have some limited proprietary right (e.g. a right of use) in the encumbered assets. That is, the security agreement cannot be concluded until the grantor actually has rights in the assets that the agreement purports to cover. This immediately raises the question as to whether the security agreement can be concluded so as to cover (a) assets in which the grantor has only a contractual right (for example, in many legal systems a lessee has no proprietary rights in leased property); and (b) future assets (for example, assets that the grantor is in the process of acquiring or intends to acquire, but that still belong to the seller, or assets that will be manufactured in the future from raw materials that may or may not already be owned by the grantor – i.e. do not even exist yet).

182. In addressing these issues, most States start from the principle that the grantor cannot grant to the secured creditor more rights than the grantor has or may acquire in the future (*nemo dat quod non habet*). This means, for example, that, if the grantor has only a contractual right to use an asset, any security right that it grants can only affect its contractual right. A lessee may only grant security in the lease agreement and not directly in the object being leased. Subject to rules that States adopt concerning the detail required for describing the encumbered asset, this means that the agreement must identify that asset as a lease, not as the leased object itself. Similarly, it means that if the grantor only has a limited right in the property (for example, a usufruct) the security right will only encumber the right of usufruct.

Increasingly, however, States are confronted with the question of whether "future" assets may be covered by a security agreement.

183. In some States, future assets of whatever kind may not be used as security. This approach is partly based upon technical notions of property law (e.g. what does not exist cannot be transferred or encumbered). It is also based on the concern that allowing broad dispositions of future assets may inadvertently result in over-indebtedness and in making the grantor excessively dependent on one creditor, preventing the grantor from obtaining additional secured credit from other sources. Another argument offered for not permitting the creation of security rights in future assets is that permitting it may significantly reduce the possibility that unsecured creditors of the grantor will obtain satisfaction for their claims. However, technical notions of property law should not be invoked to pose obstacles to meeting the practical need of using future assets as security to obtain credit. In addition, business grantors can protect their own interests and do not need statutory limitations on the transferability of rights in future assets. Moreover, permitting future assets to be encumbered makes it possible for grantors with insufficient present assets to obtain credit, which is likely to enhance their business and benefit all creditors, including unsecured creditors.

184. In other States, the parties may agree to create a security right in a future asset. The disposition is a present one but it becomes effective as to the future asset only when the grantor becomes the owner of the asset or the asset comes into existence. The United Nations Assignment Convention takes this approach (see art. 8, para. 2, and art. 2, para. (a)). Permitting the use of future assets as security for credit is important, in particular, for securing claims arising under revolving loan transactions with a revolving pool of assets. Assets to which this technique is typically applied include inventory, which by its nature is to be sold and replaced, and receivables, which after collection are replaced by new receivables. The main advantage of this approach is that one security agreement may cover a changing pool of assets that fit the description in the security agreement. Otherwise, it would be necessary to continually amend security agreements or enter into new ones, a result that could increase transaction costs and decrease the amount of credit available, in particular on the basis of revolving credit facilities.

185. The Guide takes the position that a security agreement may cover future assets. Where the security agreement provides for the creation of a security right in assets with respect to which the grantor has rights, or the power to encumber, at the time the security agreement is concluded, the security right in those assets is created at the time the security agreement is concluded. Where, however, the security agreement provides for the creation of a security right in assets with respect to which the grantor expects to acquire rights, or the power to encumber, in the future, the security right is created if and when the grantor acquires such rights or right to encumber (see A/CN.9/631, recommendations 12 and 16).

(b) Excluded assets

186. In some legal systems, special laws for specific types of non-possessory security right introduce limitations as to the types of asset that may serve as security or as to the part of the value of assets that may be encumbered. Examples of limitations justified for public policy reasons may include employment benefits (e.g. wages and pensions) under a certain minimum amount. In other legal systems,

limitations are placed on the purposes for which certain classes of grantors may grant security. For example, some States do not permit grantors to create security over household goods unless the security right is created to secure payment of the purchase price of those assets. Still other States limit the capacity of certain grantors to create certain types of security right. For example, in some legal systems, persons not carrying on a business are prevented from granting non-possessory security rights and may only pledge their assets. In other legal systems, these same persons are not permitted to grant a security right in future assets or a security right in a category of assets. Security rights may be created only in existing assets and only where those assets are described individually.

187. All these limitations, which are usually intended to protect grantors, also prevent grantors from utilizing the full value of their assets to obtain credit. Therefore, the benefits and the negative impact of such limitations need to be carefully weighed. Some States undertake this necessary balancing not by including such limitations in the general legislation establishing the regime of security rights, but by elaborating specific rules setting out appropriate limitations on the creation of security rights in special legislation such as consumer-protection legislation. This approach has the advantage of enabling States to design the limitations in a targeted manner that furthers policy objectives directly related to the protection of those grantors deemed in need of such protection.

(c) Identification of assets

188. In some legal systems, the encumbered assets need to be specifically identified. While such a requirement is intended to protect the grantor from granting excessive security rights, it also limits availability of credit in many cases. For example, specific identification of individual items may not be practical or even possible for assets such as inventory and, to some degree, receivables. To address this issue, many States have developed rules that allow the parties to describe the assets to be encumbered only in general terms. The specific identification, generally required, is transposed from the individual items to an aggregate, which in turn has to be generally identified.

189. These general descriptions can take many forms. For example, parties may provide that the security right encumbers “all inventory”, or “all inventory in warehouse ABC”, or “all sailboats and canoes”, or “all cows”, or “all printing presses” or “all receivables”. The key is neither the type of asset (equipment, inventory, receivables) nor the extent or scope of the category (“all assets in ‘X’ location” or “all sailboats and canoes” as opposed to “all watercraft”). Rather, States that permit general descriptions simply require that the description be sufficient to enable third parties to know, at any given time, what assets are encumbered by the security agreement.

190. In some legal systems, it is possible to identify encumbered assets with a description cast at a very high level of generality. In these States, even a description referring to “all assets”, or “all present and future inventory”, is sufficient. The goal is to reduce the complexity and cost of creating a security right by permitting the parties to describe the encumbered assets in the simplest language possible. As noted, however, in many of those legal systems which permit identification by reference to a category of assets, such a generic identification of encumbered assets is not allowed with respect to assets of consumers or even individual small traders.

Subject to ensuring that the identification of encumbered assets is sufficiently clear and to public policy limitations that States may desire to impose for consumer-protection purposes, this Guide recommends that general descriptions of both present and future inventory be permitted (see A/CN.9/631, recommendations 13 and 16).

(d) Security in all assets of a grantor

191. Some States, as just mentioned, do not permit grantors to create a security right in assets that are described in general terms. By contrast, many other States do. Nonetheless, even in some legal systems that permit the general identification of categories of encumbered assets and even permit a general identification of present and future assets, grantors are often not permitted to create a security right in all of their assets (that is, in even "all present and future assets"). In other legal systems, grantors are permitted to create a security right in all of their assets, but only up to a certain percentage of their total value. Such limitations, which are intended to provide some protection for grantors and unsecured creditors, are bound to limit the credit available and increase the cost of credit.

192. In order to enhance the availability of secured credit, some legal systems impose no such limitations. Grantors are permitted to create a non-possessory security right in all of their assets, including tangible and intangible, movable and immovable (although different rules may apply to security in immovable property), and present and future assets. The most essential aspects of such an all-asset security right are, first, that it covers all assets of a grantor in a single security agreement, and second, that the grantor has the right to dispose of certain of its encumbered assets (such as inventory) in the ordinary course of its business (while the security is extended automatically to the proceeds of the disposed assets). States take different approaches as to both of these aspects of all-asset security rights.

193. In many legal systems, the essential elements both as to content and as to form for the creation of a security right covering all assets are more onerous than those applicable to ordinary security rights. In other legal systems, as long as no immovable property is encumbered by the security agreement, the requirements for creating the security right are identical to those for ordinary security rights. Where immovable property is also encumbered, it is necessary that the agreement respect the substantive and formal requirements for creation of an encumbrance in immovable property. As for the grantor's right to dispose of encumbered assets without affecting the security right, most legal systems provide that the grantor may do so with the permission of the secured creditor. Some legal systems provide that, in such cases, the security right no longer encumbers the asset, while others provide that the security right still affects the asset. However, in some legal systems, dispositions of encumbered assets by the grantor, even if authorized by the creditor, are regarded as irreconcilable with the idea of a security right. In order to simplify the creation of a security right in all assets of an enterprise, where the provider of credit is financing the ongoing operation of the enterprise, this Guide recommends that single-document all-asset security agreements be permitted (see A/CN.9/631, recommendation 16).

(i) Enterprise mortgages

194. The concept of “all-asset security rights” is not novel. In some States, the idea of an all asset-security right has long existed in the form of what is often called an “enterprise mortgage”. Like an all-asset security right, an enterprise mortgage may comprise all assets of an enterprise (including, in some States, even immovable property). It may cover, for example, incoming cash, new inventory and equipment, as well as future assets of an enterprise, while present assets that are disposed of in the ordinary course of business are released. The main advantage of an enterprise mortgage is that it allows an enterprise that has more value as a whole to obtain more credit and at a lower cost. An interesting feature of some forms of enterprise mortgage is that upon enforcement by the secured creditor and upon execution by another creditor, an administrator can be appointed for the enterprise. This may assist in avoiding liquidation and in facilitating reorganization of the enterprise with beneficial effects for creditors, the workforce and the economy in general. In practice, however, administrators appointed by the secured creditor may favour the secured creditor. This problem may be mitigated to some extent if the administrator is appointed and supervised by a court or other authority. This feature of an enterprise mortgage may be usefully expanded to all-asset security rights in the sense that the administrator could be appointed by agreement of the grantor and the secured creditor or by the court and be responsible for enforcement outside insolvency.

195. Enterprise mortgages may present certain disadvantages in practice. One disadvantage is that the secured creditor usually is or becomes the enterprise’s major or even exclusive credit provider and this may affect competition among credit providers and thus negatively affect the availability and the cost of credit to the extent that other creditors are unprotected (although competition is not necessarily precluded since a single major credit provider may offer particularly competitive credit terms). In order to address this problem, some States have introduced limitations on the scope of enterprise mortgages, preserving a percentage of the value of the enterprise for unsecured creditors in the case of insolvency. However, such limitations may have an adverse impact on the availability of credit by effectively reducing the value of assets available to serve as security for credit. Another possible disadvantage of enterprise mortgages is that, in practice, the holder of the mortgage may fail to monitor sufficiently the enterprise’s business activities and to participate actively in reorganization proceedings since the mortgagee is amply secured. In order to counterbalance the mortgagee’s overly strong position, the debtor-enterprise may be given a claim for the release of grossly excessive security.

(ii) Floating charges

196. In other States, all-asset security rights take the form of a so-called “floating charge” that is merely a potential security right with a right for the grantor to dispose of certain of the encumbered assets (such as inventory) in the ordinary course of business. Dispositions are barred as of the time the debtor is in default, when the floating charge “crystallizes” to become a fully effective “fixed” charge. Once a legal system permits the creation of non-possessory security rights in all assets of a grantor while the grantor is allowed to dispose of certain of the assets in the ordinary course of its business, there is no need to preserve the construction or

the terminology of enterprise mortgages or floating charges (see also para. 199 below).

(iii) Over-collateralization

197. Related to, though distinguishable from, concerns about all-asset security is the issue of over-collateralization. The problem of over-collateralization arises in situations where the value of the encumbered assets significantly exceeds the amount of the secured obligation. While the secured creditor cannot claim more than the secured obligation plus interest and expenses (and perhaps damages), over-collateralization may create problems. The grantor's assets may be encumbered to an extent that makes it difficult or even impossible (at least in the absence of a subordination agreement between creditors) for the grantor to obtain a second-ranking security from another creditor. In addition, enforcement by the grantor's unsecured creditors may be precluded or at least be made more difficult (unless there is excess value).

198. A solution developed by courts in some States is to declare any security right grossly in excess of the secured obligation plus interest, expenses and damages void or to grant the grantor a claim for release of such excess security. This solution could work in practice, if a commercially adequate margin may be determined and granted to the secured creditor, which may not be easy in all cases. While the problem of over-collateralization is, in many cases, a real concern, the appropriate response to the concern is likely to vary from State to State and may sometimes lie in regulation of these practices in other law. For this reason, the Guide does not recommend adoption of the concept of a judicial declaration of over-collateralization (with a consequent reduction of the scope of the encumbered assets) as a solution.

(iv) Conclusion

199. Once a legal system permits the creation of non-possessory security rights in all present and future assets of a grantor under a regime that permits the grantor to dispose of certain of the assets in the ordinary course of its business, many of the particular devices that States have designed to permit businesses to obtain credit by granting security rights over the enterprise as a whole are no longer necessary. That is, concepts and terms like "enterprise mortgages" and "floating charges" were important because they performed a role in business financing that regular security rights were not able to accomplish. However, where States opt to create integrated and functionally organized regimes for the granting of security and enable grantors to encumber all their present and future assets in the same agreement, the need for these existing devises is significantly reduced, if not eliminated. While the Guide does not recommend that States dispense with "enterprise mortgages" and "floating charges", as noted it does recommend that States adopt the concept of all-asset security rights, which performs the functions performed by those other devices (see A/CN.9/631, recommendation 16).

(e) Liability of the secured creditor for loss or damage caused by the encumbered assets

200. While liability for loss or damage caused by encumbered assets (as a result of breach of contract or tort) is not a secured transactions issue, it is important that it

be addressed since it may have an impact on the availability and the cost of credit. A particularly important issue is liability for environmental damage caused by assets subject to possessory or non-possessory security rights, since the monetary consequences and the prejudice to the reputation of the lender may substantially exceed the value of the encumbered assets. Some laws expressly exempt secured creditors from liability, while other laws limit such liability under certain conditions (e.g. where the secured creditor has no possession or control of the encumbered asset). When no such exemptions from or limitations of liability exist, the risk may be too high for a lender to extend credit. Where insurance is available, it is bound to substantially increase the cost of credit.

7. Creation of a security right in proceeds

(a) Concept of proceeds

201. A characteristic feature of movable property is the fact that it is often made in order to be sold, leased or licensed. When encumbered assets are sold, exchanged or otherwise disposed of, or leased or licensed during the time in which the obligation they secure is outstanding, the grantor typically receives, in exchange for those assets, cash, tangible property (e.g. goods or negotiable instruments) or intangible property (e.g. receivables). This being the case, States must determine whether a security right that is taken in the initial property should extend to new property that is received in exchange for that property when it is sold or disposed of. So, for example, States are required to decide whether a security right in a piece of equipment like a printing press extends into the money that is received by the grantor when it sells the printing press, or into another printing press that is received in exchange for the press that has been sold. In the terminology of property law, such cash or other tangible or intangible property received in exchange upon a sale or other transfer is considered to be "proceeds of disposition". Once again, for the purposes of secured transactions law, it is often much less important whether the property received upon disposition is another object, cash, a receivable or a negotiable instrument. What matters is whether the security right may extend to this new property.

202. In some cases, the proceeds of the originally encumbered assets may generate other proceeds when the grantor disposes of the original proceeds in return for other property. Such proceeds are sometimes referred to as "proceeds of proceeds". If there is a right in proceeds of encumbered assets, it should extend to proceeds of proceeds. If the secured creditor loses its right in the proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case if there were no rights in proceeds.

203. A further feature of movable property is that it is susceptible to numerous legal and physical transformations over time. For example, if tangible movable property is an animal, various modifications are possible. Female animals give birth to offspring and produce milk. Other animals may be shorn for their wool. Still other prize animals may produce marketable products. Bees may produce honey and silk worms may produce silk. In all these situations, encumbered assets may generate other property for the grantor even without a disposition of these assets. In many legal systems, this type of property is referred to as "natural fruits".

204. Transformation also occurs in relation to intangible property. For example, a right to receive payment may carry interest; a lease of tangible property results in rental payments. These are often known as "civil fruits" or "revenues". In addition, if the tangible property is an object, it may be manufactured or transformed. Wood may become a chair. Steel may become part of an automobile. Here, the initially encumbered asset is not disposed of, but the process of manufacture turns it into another, more valuable, object. Property that results from such transformation is often called "products".

205. In other words, in the terminology of property law, these diverse new types of movable property are characterized as being "fruits, revenues, the natural increase of animals, or products". For the purposes of secured transactions law, however, the specific label is often not that important. What matters is the policy decision that States take concerning the effect of the security right in the fruits, revenues and products. That is, in each of these cases, States must decide whether a security right that is taken on the animal, steel, right to payment or the object subject to lease, may extend to any of the property "produced" by that original property.

206. In some legal systems, civil or natural fruits are clearly distinguished from proceeds arising from disposition of encumbered assets and are made subject to different rules. The difficulty in identifying proceeds of disposition and the need to protect rights of third parties in proceeds is often cited to justify this approach. Other legal systems do not distinguish between civil or natural fruits and proceeds of disposition and subject both to the same rules. The difficulty in distinguishing between civil or natural fruits and proceeds, the fact that both civil or natural fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets are among the reasons mentioned to justify this approach. Moreover, parties typically provide in their security agreement that the security taken on the initial property extends into all these other forms of property. For this reason, some States consider all these transformations to constitute "proceeds" of the originally encumbered asset. Because this is the normal contractual practice in secured transactions regimes today, in this Guide all the above transformations are considered as "proceeds" arising from the initially encumbered assets (for the definition of "proceeds", see para. 19 above).

(b) Scope of a security right in proceeds

207. A legal system governing security rights must address two distinct questions with respect to proceeds. The first issue is whether the secured creditor retains the security right if the encumbered asset is transferred from the grantor to another person in the transaction that generates the proceeds. Strictly speaking, this is not a proceeds question. Rather, it relates to the issue of whether a security right comprises what might be called a "right to follow" (for a discussion of this issue, see A/CN.9/631, recommendation 85; and chapter VII on priority of a security right as against the rights of competing claimants; A/CN.9/631/Add.4, para. 57).

208. The second issue concerns the secured creditor's rights with respect to the proceeds. The justification for a security right in proceeds lies in the fact that, if the secured creditor does not obtain such a right, its rights in the encumbered assets could be defeated or reduced by a disposition of those assets and its expectation to receive any income generated by the assets would be frustrated. If the legal system did not permit the creation of a security right in proceeds upon disposition of

encumbered assets, it would not adequately protect the secured creditor against default and thus the value of the encumbered assets as a source of credit would diminish. This result, which would have a negative impact on the availability and the cost of credit, would be the same even if the security right in the original encumbered assets were to survive their disposition to a third party. The reason for this result lies in the possibility that a transfer of the encumbered assets may increase the difficulty in locating the assets and obtaining possession thereof, increase the cost of enforcement and reduce the value of the assets.

209. A right in proceeds typically arises where the encumbered assets are disposed of because the proceeds replace the original encumbered assets as assets of the grantor. In systems that treat civil or natural fruits as proceeds, a right in such proceeds may arise even if no transaction takes place with respect to the encumbered assets (e.g. dividends arising from stocks) because this is consistent with the expectations of the parties.

210. If the secured creditor's right in proceeds is a proprietary right, the secured creditor will not suffer a loss by reason of a transaction or other event, since a proprietary right produces effects against third parties. On the other hand, granting the secured creditor a proprietary right in proceeds might result in frustrating legitimate expectations of parties that obtained security rights in those proceeds as original encumbered assets. However, in legal systems in which creation is distinguished from third-party effectiveness and priority, this result would occur only if the creditor with a proprietary right in proceeds had priority over the creditors with a right in proceeds as originally encumbered assets and such priority is determined on the basis of time of registering of a notice about the transaction in a public register. Thus, in those systems, potential financiers are forewarned about the potential existence of a security right in assets of their potential borrower (including proceeds of such assets) and can take the necessary steps to identify and trace proceeds and to obtain inter-creditor subordination agreements where appropriate.

211. Slightly different considerations apply where the proceeds in question are not proceeds of disposition, but are fruits, revenues and the increase of animals or the products of manufacture. In the last case, it would be the normal expectation of the parties that raw materials would be manufactured. The policy question is, consequently, whether a State should adopt a rule that requires a security agreement to provide explicitly that the security is taken not only in the raw materials but also in any product that is manufactured from those raw materials, or whether the assumption should be that the manufactured products are automatically covered by the security right and, if the parties do not wish this to be the case, they should so state in the security agreement. Most States do not require parties to specify that the security right passes into property manufactured from raw materials, as long as it can be clearly identified as having resulted from those raw materials.

212. Similar considerations bear on the decision as to whether parties should specify that the security right extends to offspring of animals, or whether they are automatically covered. As the normal expectation of the parties is that newborns would be covered, most States provide that a security right in the mother also automatically covers offspring. As for natural fruits (for example, wool, milk, eggs not hatched and honey), States take different positions. Many States require parties to specify in the security agreement that these natural fruits will be covered by the

agreement. Other States provide that natural fruits are automatically covered unless the parties provide otherwise. In keeping with the general orientation of this Guide to provide recommendations that would be consistent with the normal practice of parties to a security agreement, the approach adopted is to consider these natural fruits to be automatically covered by the security agreement in the animal that produces the fruits.

213. Finally, as concerns civil fruits or revenues, reasons of economic efficiency normally would suggest that a security right in the capital payment (e.g. a negotiable instrument or receivable) should also embrace a right to the interest payable. This is because payments on such instruments or receivables are often blended payments of capital and interest. Only where it is easy to separate the repayment of the capital from the interest charges, and where the parties agree that the security right in the capital sum will not extend to the separate interest generated, should the law permit the interest to be several from the initial obligation.

(c) Creating a security right in proceeds

214. The discussion above shows that there are practical reasons why many legal systems extend security rights in encumbered assets to various forms of proceeds (including proceeds of proceeds) through default rules applicable in the absence of an agreement to the contrary. In other legal systems, where an automatic right in proceeds does not exist, whether in respect of proceeds of disposition or in relation to one or more categories of fruits, increase of animals, revenues or products, parties are typically permitted to specify that they will take security rights in all types of asset as originally encumbered assets. In such systems, parties may be free to provide, for example, that a security right is created in substantially all of the grantor's assets (cash, inventory, receivables, negotiable instruments, securities and intellectual property). In such a way, the proceeds themselves become originally encumbered assets and are covered by the security right of the creditor even without a legal rule automatically providing a right in proceeds. In some of those legal systems, parties may also extend by agreement certain title-based security rights (e.g. retention of title) to proceeds.

215. Regardless of whether a right in proceeds flows automatically from a right in the originally encumbered assets, or whether it must be explicitly mentioned in the security agreement, there are no additional formalities imposed on parties that seek to claim a right in any of these forms of proceeds. The only requirement is that, in the former case, the security agreement should specify a right in the proceeds and indicate the kinds of proceeds that are meant to be included in the same security right, while in the latter case, it is sufficient to identify clearly the assets that are subject to the initial security right. In line with its general objective of facilitating secured credit, this Guide recommends approaches that will reflect the normal expectations of grantors and secured creditors that a security right in encumbered assets automatically extends to its identifiable proceeds without the need for parties to so provide in their security agreement (see A/CN.9/631, recommendation 18).

8. Commingled proceeds

216. When the assets that constitute proceeds of encumbered assets are not kept separately from other assets of the grantor, the question arises as to whether the

security right in the proceeds is preserved. The answer to this question usually depends on whether the assets constituting proceeds are identifiable. Proceeds in the form of tangible property kept with other assets of the grantor can be identified as proceeds in any manner that is sufficient to establish that the items of tangible property are proceeds. In this respect, many States provide that the same principle that governs the preservation of the secured creditor's right in originally encumbered assets that has been commingled should also apply to tangible property that constitutes commingled proceeds. So, for example, if a grantor receives a certain amount of petrol as a swap for crude oil that has been sold and the petrol is commingled in a tank, the security right should continue into a proportion of the petrol in the tank as long as the secured creditor can prove that that amount of petrol was received as proceeds, and no additional steps are required in order to create (or preserve) the security right in these commingled tangible proceeds.

217. If, by contrast, the property constituting proceeds is intangible, such as receivables or rights to payment of funds credited to a bank account, and is not maintained separately from the grantor's other assets of the same type, such intangible property may be identified as proceeds as long as it can be traced to the originally encumbered assets. For example, as long as the secured creditor can prove that a certain amount of cash has been deposited as proceeds of the disposition of encumbered assets, then a proceeds claim could arise. The difficulty is that money is constantly entering and exiting from bank accounts and it is difficult to know what percentage of the money actually originated as proceeds.

218. Many States have quite complicated rules developed within banking practice to determine when funds deposited in a bank account can be traced. Examples of different tracing rules include (a) "first-in, first-out" ("FIFO"), which assumes that the first property to become part of a commingled mass is the first property withdrawn from the mass; (b) "last-in, first-out" ("LIFO"), which assumes that the last property to become part of a commingled mass is the first property withdrawn from the mass; and (c) the "lowest intermediate balance rule" ("LIBR"), which assumes, to the extent possible, that withdrawals from the commingled mass are not proceeds of the encumbered assets. Many States protect the security right by providing that the identifiable proceeds will consist of all funds deposited as proceeds, as long as the balance of the account is greater than the amount deposited as proceeds. Where the total amount is less than the total amount of proceeds deposited to the account, the identifiable proceeds are determined by taking the lowest intermediate balance and adding to it any further money in the form of proceeds added to the fund since that lowest balance was recorded. As with the case of commingled tangible proceeds, as long as the source of the intangible proceeds can be traced, no further steps need be taken by the parties in order to create (or preserve) the security right in these commingled intangible proceeds (see A/CN.9/631, recommendations 19 and 20; for priority in proceeds, see chapter VII, A/CN.9/631/Add.4, paras. 48-51).

9. Commingled tangible property

219. Historically, secured transactions regimes did not face the problem of maintaining identification of encumbered assets. Because security rights could be taken only in individually identified assets, it was rare that commingling of fungible property could arise. Today, however, many States permit parties to create a security

right in a general category of (usually fungible) property. For example, the security could be taken in assets described as “all my present inventory of personal computers”; alternatively, a seller could take security in all the personal computers that it sells to a purchaser. In both these cases, it may be that assets subject to the security right are commingled in a manner that prevents separate identification with other assets of the same type that are not subject to the security right.

220. Two approaches are possible. Some States provide that, once the property is commingled, it is no longer identifiable and the creditor’s security right is lost. This approach places the burden on the secured creditor to ensure that the grantor keeps the encumbered assets separated from other assets of a similar nature to prevent commingling. Other States provide that the security right survives and may be claimed in the commingled assets in the same proportion as the encumbered asset bore to the total amount of the commingled assets. Under this approach, if $100,000 worth of oil is commingled with $50,000 worth of oil in the same tank, the secured creditor is deemed to have security over two-thirds of whatever oil remains in the tank at the moment it becomes necessary to enforce the security.

221. As this Guide adopts the general principle that security rights should be protected as much as possible, it recommends that the second approach (i.e. preservation of the security right in the commingled property in the same proportion as the encumbered assets and the assets not encumbered by the security contributed to the mass) be adopted. In other words, once a security right is created in the encumbered assets, no further steps are necessary to preserve that security right should the encumbered asset ultimately be commingled with similar assets of the same type that are not subject to the security right (see A/CN.9/631, recommendation 21).

10. Tangible property commingled in a mass or product

222. When tangible property is so mixed with other tangible property that its separate identity is lost in a product or mass, it is necessary to determine the conditions under which a security right in the original asset may be claimed in the product that has been produced. For example, it may be that a security right is taken in flour that is destined to become bread through manufacturing or production. Two basic approaches are taken in various legal systems. In some States, once the flour loses its identity as flour, the security right is extinguished. If the parties wish the security right to pass into the bread, it is necessary to provide that the original security encumbers both flour and any product into which the flour may be transformed or manufactured. Other States take the position that the security right automatically passes into the manufactured product as long as it can be established that the product resulted from the raw materials subject to the security right. As it is the normal expectation of the parties that the raw materials will be manufactured, this Guide takes the position that it should not be necessary to provide in the security agreement that the security right passes into the manufactured product. The resulting product is in some sense the replacement or substitute for the security right in the no longer existing raw materials (see A/CN.9/631, recommendation 21).

11. Creation of a security right in an attachment

223. Movable property may be attached to movable or immovable property in such a way that its identity is not lost and it becomes an attachment (for the definitions of

"attachment to movable property" and "attachment to immovable property", see para. 19 above). In these cases, the question arises as to whether a security right, to which the original movable was subject before attachment, is preserved.

224. In some States, it is not possible to create a security right in an attachment that has already become attached to other property (whether movable or immovable). In order to be effective against the attachment, the security right has to be created prior to attachment. However, in these States, a security right in an item of movable property may continue if it becomes an attachment to immovable or movable property regardless of the cost or difficulty of removing the attachment from the property to which it was attached and regardless of whether the attachment has become an integral part of that property (see A/CN.9/631, recommendation 22). In other States, it is also possible to create a security right in an item of movable property that is already an attachment, whether the attachment is to immovable property or to other movable property. For these States, the cost or difficulty of detachment is also irrelevant to determining if the security right may be created. In some States, a security right may be created in an item of movable property that is an attachment to immovable property. In both cases, whether the attachment may be readily removed without damage from the property to which it is attached is relevant for determining the priority among competing claimants (see A/CN.9/631, recommendations 93-95), but is not relevant to the question of whether the security right may be created.

225. The key issue is to determine whether any additional steps must be taken to create a security right in an item of property that is an attachment beyond those necessary to create an ordinary security right. Except in those States that do not distinguish between creation, third-party effectiveness and priority, no additional steps are required since this is an issue of creation, not priority.

12. Creation of a security right in a mass or product

226. As noted, an item of tangible property may be commingled with one or more other items of tangible property in such a way that its identity is lost. In this case, the question arises as to whether a security right to which the original item of tangible property was subject before commingling, is preserved. The general position of most States is that the security right is preserved following commingling, assuming that the source of at least some of the commingled property can be identified as being initially encumbered property (see A/CN.9/631, recommendation 23). The security right in the originally separate property is converted into a security right in the product or mass (as to priority of competing claims in commingled goods, see A/CN.9/631, recommendations 96-98).

227. However, and in contrast to the general approach taken to the creation of security rights in attachments, in most States a security right may not be created in items of tangible property after they have been commingled. That is, while an attachment can always be seen to have at least a notional separate identity, where oil is commingled in a tank, or flour is manufactured into bread, the separate identity of the initially encumbered asset disappears. For this reason, it is generally not possible to create a separate security right in items of property that have already been commingled. That is the approach adopted in this Guide (see A/CN.9/631, recommendation 23).

B. Asset-specific recommendations

1. Effectiveness of a bulk assignment of receivables and an assignment of future, parts of and undivided interests in receivables

228. With respect to the assignment of receivables, which is widely used in important financing transactions, a trend is developing whereby the assignment is subjected to the same provisions whether it involves an outright transfer, an outright transfer for security purposes or a security transfer. This trend is mainly justified by the fact that it would be very difficult for third parties to determine the nature of an assignment, as well as by the need to have the same priority rules govern all types of assignment. This trend is reflected in the United Nations Assignment Convention (see art. 2). However, legal systems differ as to the requirements for an effective assignment. Some legal systems require a writing or notification of the debtor of the receivable. Other legal systems require a writing for the assignment to be effective as between the assignor and the assignee and registration for it to be effective as against third parties. Legal systems also differ with respect to the effectiveness of assignments of future receivables and receivables not specifically identified, as well as with respect to the effectiveness of assignments made despite anti-assignment clauses in the contracts from which the assigned receivables arise. The United Nations Assignment Convention validates all these assignments (see art. 8 of the Convention, reflected in A/CN.9/631, recommendation 24).

2. Effectiveness of an assignment of receivables made despite an anti-assignment clause

229. In some States, effect is given to contractual restrictions on dispositions in order to protect the interest of the party in whose favour the restriction is agreed upon (i.e. the assignor or the debtor of the receivable). In other States, no effect or only a limited effect is given to contractual restrictions on dispositions so as to preserve the grantor's freedom of disposition, in particular if the person acquiring a right in an asset is not aware of the contractual restriction.

230. The United Nations Assignment Convention takes a similar approach to support transferability of receivables, which is in the interest of the economy as a whole. If the assignor is able to obtain credit on the basis of its receivables, it is likely to extend credit to the debtor of the receivable; effectiveness of the assignment is also in the interest of an assignee that provides credit to the assignor. Debtors that require protection, such as a consumer or a State, may protect themselves through statutory prohibitions.

231. Under article 9, paragraph 1, of the United Nations Assignment Convention, an assignment is effective despite a contractual restriction on assignment agreed upon between the assignor ("grantor" in the terminology of the Guide) and the debtor ("debtor of the receivable" in the terminology of the Guide). However, the effect of this provision is limited in two ways. First, its application is limited to broadly defined trade receivables (see art. 9, para. 3, of the Convention); and second, if such a contractual restriction is valid under law applicable outside the Convention, article 9 does not invalidate it as between the assignor and the debtor of the receivable (see art. 9, para. 2). The grantor is free to claim damages from the assignor for breach of contract, if such a claim exists under law applicable outside

the Convention, but may not raise this claim against the assignee by way of set-off (see art. 18, para. 3). In addition, mere knowledge of the existence of the restriction on the part of the assignee ("secured creditor" in the terminology of the Guide) is not enough for the avoidance of the contract from which the assigned receivable arises (see art. 9, para. 2).

232. This approach promotes receivables financing transactions since it relieves the assignee (i.e. the secured creditor) of the burden of having to examine the contracts from which the assigned receivables arose in order to ascertain whether transfer of the receivables has been prohibited or made subject to conditions. Otherwise, lenders would have to examine a potentially large number of contracts, which may be costly or even impossible (e.g. in the case of future receivables, see A/CN.9/631, recommendation 25).

3. Creation of a security right in a personal or property right securing a receivable, a negotiable instrument or any other intangible asset

233. If a grantor creates a security right in a receivable, negotiable instrument or any other intangible asset in favour of a secured creditor, the issue arises as to whether the secured creditor also has, automatically and without any further action by the grantor or the secured creditor, the benefit of any personal right (e.g. a guarantee) or property right (e.g. a security right in other movable property or a mortgage on immovable property) that secures payment of the receivable, negotiable instrument or other payment claim.

234. A strong case can be made that the creation of the security right in the receivable, negotiable instrument or other intangible asset should also automatically give the secured creditor the full benefit of the grantor's full set of rights with respect to that receivable, negotiable instrument or intangible asset. Thus, if the obligation to pay the receivable, negotiable instrument or other intangible asset is itself secured by a security right in an asset of the obligor, the secured creditor should also receive the benefit of the grantor's rights with respect to the security right in the obligor's asset (see A/CN.9/631, recommendation 26, subpara. (a)).

235. The recommendation described in the preceding paragraph should apply regardless of whether the grantor is limited by any agreement with the debtor of the receivable or the obligor on the negotiable instrument or other intangible asset from creating a security right in (a) the receivable, negotiable instrument or other intangible asset; or (b) the personal or property right securing payment of performance of the receivable, negotiable instrument or other intangible asset (see A/CN.9/631, recommendation 26, subpara. (d)). However, nothing contained in such recommendation should affect the grantor's liability for breaching that agreement, except that the other party to the agreement may not avoid the agreement giving rise to the receivable, negotiable instrument or other intangible asset, or the property right securing the same, upon the sole ground of that breach (see A/CN.9/631, recommendation 26, subpara. (e)).

236. However, because the secured creditor's rights with respect to the personal or property right flows from the grantor's rights, the secured creditor's rights with respect to that personal or property right cannot be greater than the grantor's rights with respect to it.

237. Where the receivable, negotiable instrument or other intangible asset is secured by an independent undertaking, the secured creditor's security right does not extend to the right to draw under the independent undertaking, but rather extends only to the proceeds under an independent undertaking (see A/CN.9/631, recommendation 26, subpara. (b)). This is consistent with the theme of the Guide that a beneficiary of an independent undertaking may not transfer the right to draw without the consent of the guarantor/issuer, confirmer or other nominated person.

238. There are several practical reasons supporting the recommendation that the secured creditor should have a security right in the proceeds under an independent undertaking. First, this result merely eliminates the need for the secured creditor to take certain additional steps in its loan documentation with the grantor. That is because, even if the Guide were to make the distinction between an accessory right and an independent right, since that distinction is made under the laws of a number of States, that distinction would not prevent the secured creditor from obtaining a security right in proceeds under an independent undertaking. It would merely require the secured creditor to take the formalistic steps of including an express creation of a security right in the proceeds under an independent undertaking in its security agreement with the grantor. Eliminating the need for such formalism furthers the Guide's goal of reducing the costs of credit and making more credit available by reducing transaction costs.

239. Second, the automatic creation rule for a security right in proceeds under an independent undertaking would make sense in practice as being consistent with the parties' normal expectations. A secured creditor looking to the grantor's receivables as encumbered assets would normally expect that, regardless of how the receivables owed were paid (e.g. whether directly by the debtors of the receivables or by a draw under an independent undertaking securing one or more of the receivables, the secured creditor would have a security right in the payment as proceeds of the receivables. Indeed, in some cases a secured creditor may be willing to extend credit to a given borrower at a lower rate if the secured creditor knows that its security right in the receivables owed to its borrower includes a security right in the right to proceeds under an independent undertaking in so far as those receivables are secured by the independent undertaking. A rule that is consistent with the parties' normal expectations will avoid unfair surprise and create greater certainty in States that enact the recommendations of the Guide. Greater certainty will make credit providers more confident in extending credit and accordingly will further the goal of the Guide to encourage the greater availability of secured credit.

240. Third, the recommendation does not affect in any way the rights of the guarantor/issuer, confirmer or any nominated person under the independent undertaking. Neither the guarantor/issuer, nor any confirmer nor any nominated person has any obligation to accept a drawing from anyone other than the beneficiary of the independent undertaking, or has any obligation to pay anyone other than the beneficiary, without the consent of the guarantor/issuer, confirmer or nominated person.

241. The Guide qualifies the foregoing recommendation in a number of important respects. First, it does not affect a right in immovable property that, under law other than the secured transactions law, is transferable separately from the receivable, negotiable instrument or other intangible asset that it secures. This recommendation addresses the device that may exist in some States which permits an owner of

immovable property to create a right (mortgage) in the immovable property even though at the time of creation the right does not secure any obligation. The owner may then transfer that right to a creditor that may in turn transfer the right to another creditor. Like an independent undertaking, the right in the immovable property appears to be a right in itself independent of any obligation.

242. The second qualification is that, consistent with the United Nations Assignment Convention, the recommendation applies only to certain types of receivable, negotiable instrument or other intangible asset (see A/CN.9/631, recommendation 26, subpara. (f), such as "trade receivables" (e.g. receivables evidencing the sale of goods and services).

243. The third qualification is that the recommendation does not affect any obligations of the grantor to the debtor of the receivables or the obligor on the negotiable instrument or other intangible asset (see A/CN.9/631, recommendation 26, subpara. (g)).

244. Finally, the recommendation would not affect any requirement under law other than the secured transactions law relating to the form or registration of the creation of a security right on any asset that secures payment or performance of a receivable, negotiable instrument or other intangible asset, but only to the extent that the automatic creation of the benefit of such security right is not impaired (see A/CN.9/631, recommendation 26, subpara. (h)).

4. Creation of a security right in proceeds under an independent undertaking

245. It is well established under the law and practice governing independent undertakings in many States that the right to draw under an independent undertaking may not be transferred without the consent of the guarantor/issuer, confirmer or nominated person under the independent undertaking. The Guide recognizes and respects this principle.

246. However, the Guide also draws a distinction between the right to draw under an independent undertaking and the right to receive the proceeds of a draw under an independent undertaking. Furthermore, the Guide takes the position that nothing in the law or practice governing independent undertakings prevents the beneficiary of an independent undertaking from creating a security right in the proceeds of the undertaking (i.e. the right to receive the proceeds once payment is made), even if the right to draw under the undertaking is itself not transferable under applicable law and practice (see A/CN.9/631, recommendation 28).

5. Creation of a security right in a negotiable document or goods covered by a negotiable document

247. When a negotiable document has been issued with respect to goods and is outstanding, the document embodies the title to the goods. As a result, it is appropriate that the creation of a security right in the negotiable document also operates as the creation of a security right in the goods themselves, provided that the security right in the document is created while the issuer is in possession of the goods (see A/CN.9/631, recommendation 29). For this purpose, possession may be direct (e.g. by the issuer of the document) or indirect (e.g. by an agent on behalf of the issuer of the document; for the definition of "possession", see para. 19 above).

C. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.*]