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Note by the Secretariat*

Addendum

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V. Effectiveness of a security right against third parties

A. General remarks

1. Introduction

(a) Purpose of third-party effectiveness requirements

1. In some States, a security right in movable property takes effect both between the parties and against third parties as soon as the security agreement is concluded without the need for any further act. This approach has the advantage of simplicity. However, it does not provide a potential secured creditor with a reliable means of verifying whether assets in the grantor's possession are already encumbered. In addition, if the grantor sells or transfers possession of an encumbered asset, without the authorization of the secured creditor, to a buyer (and sometimes a pledgee) that purchases (or takes possession of) an asset without knowledge that it is already subject to a security right, a secured creditor may find its security right defeated. This result is likely to have a negative impact on the availability and the cost of credit.

2. Many States, therefore, require an additional step to be taken for the security right to become fully effective. This additional step is designed to provide some form of public notice of the actual (and in some cases merely the potential) existence of a security right in the grantor's assets. Examples of such acts include the transfer of possession of the encumbered assets to the secured creditor and the registration of a notice in a public registry. These types of acts contribute to the efficiency and effectiveness of a regime of secured lending in several ways. First, they enable a secured creditor to determine in advance of taking a security right whether the grantor's assets are already encumbered. Second, as they alert the grantor's creditors and other third parties to the existence of the security right, there is no need for special rules protecting third parties against the prejudice of "secret" security rights Third, they provide a defined temporal event for the ordering of priority between a secured creditor and a competing claimant (for the definitions of "competing claimant" and "secured creditor", see A/CN.9/631/Add.1, para. 19).

(b) Distinction between creation and third-party effectiveness

3. Among States that require such an additional act, some treat it as a prerequisite to the effectiveness of the security right even as between the parties. The idea here is that, as a central goal of taking security is to obtain rights enforceable against the grantor and third parties, there is no utility in distinguishing between effectiveness between the parties and third-party effectiveness. In other States, the additional step is required only for the purposes of making the security right effective against third parties. This approach is based on the idea that, as the requirement for taking an additional step is aimed primarily at ordering the priority of rights between a secured creditor and a competing claimant, there is no reason why it should be a pre-condition to the right of the secured creditor to enforce its rights under the security agreement and secured transactions law as against the grantor (for the definition "security agreement", see A/CN.9/631/Add.1, para. 19).

4. Many States that have recently modernized their secured transactions law adopt the second approach. In States that do not recognize a distinction between *inter*

partes and *erga omnes* effects of property rights generally, adoption of this approach may generate some conceptual concerns. For example, most States do not admit that a pledge may be created only between the parties. Nonetheless, the approach of the Guide is not entirely novel even in these States. It merely carries the idea of consensualism, which is now accepted as part of the law of sale in most States, into the realm of security rights. Moreover, concerns about recasting "property" agreements like pledge, do not apply if the additional step is registration, since in such cases the grantor always remains in possession of the encumbered asset. Finally, not drawing the distinction between *inter partes* and *erga omnes* effects adds an additional formality to the creation of a security rights without any compensating advantage to grantors or secured creditors (see A/CN.9/631/Add.1, paras. 143-147).

5. In order to promote efficient secured credit, this Guide recommends adoption of the approach that distinguishes between steps required for creation (effectiveness between the parties) of a security right and those necessary to achieve third-party effectiveness. Once the conditions for creation of a security right addressed in chapter IV (see A/CN.9/631/Add.1) are satisfied, the security right becomes effective between the grantor and the secured creditor (see A/CN.9/631, recommendation 31). However, in order for the security right to affect third parties, the requirements for third-party effectiveness addressed in this chapter must also be satisfied (see A/CN.9/631, recommendation 30).

(c) Meaning of "third parties"

6. While it is normally not difficult to determine who are the parties to a security agreement (i.e. the grantor and the secured creditor) defining who is to be considered a "third party" is more complex. Indeed, States take quite different approaches to the categories of third parties against which a security right is ineffective unless the required additional step is taken. In some States, a security right has no effect against third parties, whatever their status, until the additional step is taken. Other States adopt a second, more qualified, approach. A security right is presumptively effective against third parties upon creation but can be defeated by specified categories of competing claimants if the additional step required for full-fledged effectiveness is not taken before their rights arise (see A/CN.9/631/Add.1, paras. 143-147).

7. In States that adopt the more qualified approach, the additional step is required only for effectiveness against secured creditors and transferees of the encumbered assets. As against the grantor's unsecured creditors and the insolvency representative, the security right is fully effective upon its creation. The distinction between these categories of "third parties" is based on the idea that notice of a security right should matter only to creditors that are presumed to be those that have taken a security right or purchased or otherwise given value in reliance on the grantor's unencumbered title. For example, unsecured creditors are presumed not to rely on the presence or absence of security rights in the grantor's assets, since the very act of extending credit on an unsecured basis implies an informed acceptance of the risk of subordination to secured creditors that may later acquire security rights in the grantor's assets.

8. There are, nonetheless, several reasons why this approach to rights of unsecured creditors, judgement creditors and insolvency representatives may not be well suited

to an efficient secured transactions regime. First, while unsecured creditors base their decision to lend on the grantor's general financial health, the presence or absence of security rights may be one of the factors upon which that assessment is based and may also be relied upon by credit reporting agencies on whose services unsecured creditors may rely. Second, the requirement for timely public registration or some equivalent additional step reduces the risk that an alleged security right is a collusive arrangement between an insolvent grantor and a preferred creditor to defeat the claims of other unsecured creditors. Third, it enables judgement creditors to determine in advance of initiating costly enforcement action whether the grantor's assets are already encumbered. It also reduces the costs of insolvency proceedings by giving the insolvency representative an efficient means of ascertaining which assets of the insolvent grantor are potentially encumbered. Finally, the risk of finding its security right defeated by intervening judgement enforcement or insolvency proceedings provides a significant incentive to secured creditors to make their security rights fully effective in a timely fashion.

9. In some States that generally protect the rights of subsequent secured creditors or transferees against security rights that have not been made effective against them through the required additional step, an exception is made where these subsequent secured creditors or buyers acquire their rights with actual knowledge of the existence of a prior security right. Again, there are reasons why this qualification is not well suited to an efficient secured transactions regime. First, a key objective of an efficient regime is to provide a priori (i.e. in advance of the conclusion of the security agreement and extension of credit) certainty in the ordering the competing rights to encumbered assets. A priority rule that depends on fact-specific ex post facto litigation is inimical to that goal. Second, mere knowledge of the existence of a prior security agreement does not imply bad faith on the part of a subsequent secured creditor. If the prior secured creditor has not taken the steps necessary to make its security right fully effective against third parties, the subsequent creditor may reasonably assume that it has implicitly consented to the risk of subordination. Third, establishing knowledge on the part of another party and the exact extent of knowledge raises difficult questions of proof.

10. Some States also deny protection to a subsequent donee of an encumbered asset on the theory that, as between a secured creditor that by definition has given value for its security right and a donee that has not, the secured creditor should be protected. For reasons similar to those just canvassed in the preceding paragraph, this qualification is not well suited to efficiency in the secured lending regime. Determining the status of a transferee of an encumbered asset invites ex post facto litigation contrary to the goals of achieving a priori certainty and predictability. Moreover, even if the donee's status is not contested, the donee may well have changed its position in reliance on the unencumbered status of the asset (for example, by creating a security right in favour of another creditor).

11. The above-mentioned discussion of different approaches to determining whether certain categories of competing claimants should either be (i) subordinated to even security rights that have not been made effective against third parties, or (ii) have priority even over security rights that have been made effective against third parties at a later time illustrates that such distinctions are generally inimical to efficiency, transparency and predictability in the secured transactions regime. For this reason, this Guide recommends the first approach noted above (see A/CN.9/631,

recommendation 30). Until the conditions for third-party effectiveness are satisfied, the security right is ineffective against intervening rights in the encumbered assets acquired by third parties regardless of the type of the competing claimant.

(d) Relationship between third-party effectiveness and priority

12. Attaining third-party effectiveness does not, of itself, determine questions of priority. It does produce though some priority consequences in the sense that a security right that has not been made effective against third parties cannot be set up as against the rights of a competing claimant in the same encumbered assets. However, as between competing claimants, all of whom have achieved third-party effectiveness of their rights, additional rules are required. As explained more fully in chapter VII (see A/CN.9/631/Add.4, paras. …), priority depends upon the nature and status of the rights with which the security right is in competition. For example, if more than one security right have been made effective against third-parties, it will be necessary to rank the competing security rights as between themselves.

13. Moreover, the concept of priority is not identical in every State. Some States take the position that priority speaks only to the rights of competing secured and unsecured creditors in the assets of the grantor. The rights of other competing claimants such as transferees and lessees are determined by reference to rules governing the character of the transferor's title. Other States have a broader, functional, concept of priority. Every conflict between competing claimants is a priority dispute. This approach to priority is common whenever the secured transactions regime considers that, in relation to third-party effectiveness, no distinction should be drawn between different categories of claimant.

14. As this Guide adopts the latter concept of third-party effectiveness, it also adopts the broader concept of priority. In other words, even though third-party effectiveness and priority are distinct concepts, because the various priority rules set out in chapter VII conceive priority in relative terms, it is essential to take these priority rules into account in assessing the degree of protection afforded by third-party effectiveness or by particular methods of achieving third-party effectiveness. For example, this chapter recognizes that, once the requirements for third-party effectiveness have been satisfied, a security right continues in the asset even in the hands of a subsequent transferee (see A/CN.9/631, recommendation 32). However, the secured creditor's right to follow the assets (its *droit de suite*) is not absolute. Under the priority rules addressed in chapter VII, a buyer of an encumbered tangible asset and a holder of negotiable documents and instruments transferred in the ordinary course of the grantor's business generally take free of a security right even when it is effective against third parties (see A/CN.9/631, recommendations 85-87).

(e) Overview of methods for achieving third-party effectiveness

15. Historically, States devoted little attention to developing and reconciling different methods for achieving third-party effectiveness. This lack of attention can be traced to either a general prohibition on non-possessory security rights over movable property (movable property is not susceptible to hypothecation) or to the general unenforceability against third parties of non-possessory security rights in movable property. In these States, the pledge was the only available security device, and grantor dispossession served both to constitute the pledge, as well as provide the publicity function necessary for third-party effectiveness. As economies developed,

however, the limits of the pledge became more obvious. A commercial grantor would normally wish to remain in possession of its business assets, so some alternative to possession had to be developed. Hence, States came to develop the concept of registration of rights as an additional means for achieving third-party effectiveness.

16. In many States, registration is the principal method for achieving third-party effectiveness. While there are different types of registration regimes in different States, a frequent approach is to establish a general security rights registry (see A/CN.9/631, recommendation 33). In addition to registration, alternative methods are also available, depending on the nature of the encumbered assets (see A/CN.9/631, recommendation 35). For example, almost all States provide for the continuance of the "pledge" idea in the sense that a security right in tangible property may be made effective against third parties by a transfer of possession of the pledged asset to the secured creditor.

17. While registration in a general security rights registry and transfer of possession to the secured creditor are the most common methods for achieving third-party effectiveness, they are typically not exclusive. Specialized "control" rules are often enacted to apply to a security right in a right to payment of funds credited to a bank account and in a right to proceeds under an independent undertaking (for the definition of these terms, see A/CN.9/631/Add.1, para. 19). Furthermore, in most States a security right in an attachment to immovable property can be made effective against third parties by registration in the immovable property registry. Finally, under other law in many States, a security right in a specific type of movable property can be registered in a title registry (for example, a ship's registry) or noted on a title certificate.

18. In some States, it is also possible to achieve third-party effectiveness of a security right in a receivable by notifying the debtor of the receivable. In practice, a secured creditor generally will not demand direct payment of receivable until there is a default on the part of the grantor. Indeed, even when receivables are assigned outright, the assignee will frequently wish to leave collection in the hands of the assignor. In light of these practicalities, the Guide treats a demand for payment simply as a collection or enforcement technique and not a method for achieving third-party effectiveness. In addition, registration offers a more efficient means for secured creditors and assignees to evaluate priority risk at the outset of the transaction particularly where the security right or assignment covers all of the grantor's present and after-acquired receivables. Otherwise, they would be subject to the risk of a loss of priority based on the arbitrary timing of when a competing secured creditor or assignee happened to give notice to the debtor on the receivable.

19. Notwithstanding the principle that an additional step is required in order to achieve third-party effectiveness of a security right, some States provide that in a number of exceptional instances, a security right is automatically effective against third parties without the need for the secured creditor to register or take possession or perform any other positive step. However, as a general rule in most States, the security right becomes effective against third parties only if it is made effective against third parties by one or another of the alternative methods just outlined.

20. In most States, these alternative methods are not exclusive. For example, most States provide that where a security right may be made effective against third parties

by transfer of possession to the secured creditor, it may also be made effective by registration. Moreover, even where assets are encumbered by the same security agreement, most States provide that different methods may be used for different assets (see A/CN.9/631, recommendation 37). The one exception to the principle of non-exclusivity flows from the particular character letter of credit transactions (the Guide uses the term "independent undertaking; for the definition, see A/CN.9/631/Add.1, para. 19). Invariably States provide that a security right created in proceeds under an independent undertaking can only be made effective against third-parties by the secured creditor taking control with respect to the proceeds (see A/CN.9/631, recommendation 36).

21. This said, in many States registration may, in practice, be an exclusive method in the sense that no other method is available to achieve third-party effectiveness for the particular type of encumbered asset in question. This is generally true, for example, for security rights in receivables and inventory.

(f) Outline of chapter

22. Sections A.2 through A.4 of this chapter discuss in detail the three most common methods for achieving third-party effectiveness (i.e. registration in a general security rights registry, possession and registration in a specialized registry). Sections A.5 through A.7 consider cases where a security right that has been made effective against third parties continues to be effective in assets not initially subjected to the security right. Sections A.8 and A.9 address other issues of continuity, for example where the asset or the grantor changes location, or where third-party effectiveness may have lapsed.

23. Part B is devoted to a discussion of particular methods for achieving third-party effectiveness that apply to specific types of asset. Section B.1 considers the important cases of security right in a personal or property right securing the payment of a receivable, negotiable instrument or any other intangible asset. Section B.2 reviews third-party effectiveness of security over the right to payment of funds credited to a bank account. Section B.3 assesses how third-party effectiveness may be achieved where the security encumbers the right to proceeds under an independent undertaking. Finally, section B.4 addresses third-party effectiveness of a security right in a negotiable document or in property covered by a negotiable document.

24. Part C sets out a series of recommendations about methods for achieving third-party effectiveness and the consequences of doing so.

2. Registration in a general security rights registry

(a) General

25. While public registration is a widely accepted method of achieving third-party effectiveness, registry systems differ widely. In many States, registration requirements have evolved incrementally over a long period of time, resulting in a patchwork of uncoordinated systems within the same State organized according to diverse criteria. For example, some of these systems may be organized by reference to the type of transaction (for example, retention-of-title and hire-purchase registries). Other systems may be organized by reference to the status of the grantor (for example, corporations or commercial enterprises), or by reference to the

identity of the secured creditor (for example, banks). Still other systems may be organized by reference to the type of encumbered assets (for example, equipment or machinery or receivables registries).

26. States also take different approaches to the formalities that must be followed to register. Some require only a notice to be registered. Other States require that a full summary of the rights set out in the security agreement be registered. Still other States require that the full security documentation to be registered along with formal certificates or affidavits attesting to the identity of the participants and the authenticity of their signatures and legal capacity.

27. Beginning in the latter part of the twentieth century, an increasing number of States came to establish new registries or to significantly reorganize or replace their existing registry systems with respect to security rights in movable property. These reforms involved two distinct developments. In the first place, where existing systems were dispersed and fragmented, States replaced them with a central general registry covering all security rights in movable property, regardless of the identity of the parties, the nature of the encumbered assets or the form of the transaction giving rise to the security right. Likewise, States that established for the first time a registry for security rights in movable property invariably opted for a central general registry. Secondly, in most of these systems, States also substantially changed the mechanics of registration. The goal was to substitute the registration of a simple notice containing only minimal details about the security right to which it relates for the more cumbersome system of registering either the security documentation or a certified summary of it. That is, in these systems, the security agreement that creates the security right is not registered, nor is its existence or content verified by the system.

28. For many States, this second feature of modern registries constitutes a significant departure from the generally accepted concept of registration of security rights. Even in those States where full documentation is not registered, the idea is that the registry serves to inform searchers about an existing security right. The registration proves the right, and therefore can only be made once the right comes into existence. This explains why it is thought to be confusing, if not incoherent, to describe these modern registries as involving registration. As the secured creditor normally will simply register a notice about either its intention to take a security right (whether or not it has already acted on that intention), many States prefer to describe these registers not as registry systems, but as “notice filing” systems.

29. Regardless of the nomenclature used to describe these newer systems for achieving third-party effectiveness, it is apparent that they greatly simplify the process of providing a reliable source of information about potential security rights. When combined with advances in computer technology, a “notice-filing” system constitutes a highly efficient and cost-effective registration and searching process. For these reasons, this Guide recommends that States establish public registry systems that (i) are centralized, general and comprehensive of all security rights, and (ii) that require only the registration of a notice that sets out the basic details about the security right to which is does or may relate. It also endorses the idea that registration of a notice of a security right in such a registry should be established as a general method of achieving third-party effectiveness (see A/CN.9/631, recommendation 33). The design and operational details of different systems for

establishing such a registry are addressed in chapter VI of this Guide (see A/CN.9/631/Add.3).

(b) Registration separate from creation of the security right

30. As noted in the preceding discussion, States have traditionally taken two different approaches to the relationship between registration and creation of a security right. In some States, the right itself is only created once registration has occurred. In other States, registration is required only as an additional step necessary to achieve third-party effectiveness. This Guide recommends adoption of the second approach (see A/CN.9/631, recommendation 30).

31. Several important consequences flow from the idea that registration of a simple notice containing only basic details about the security right concerns only third-party effectiveness. The security agreement to which the notice relates is not registered. Nor is its existence or content shown to or verified by the registry system. Creation of the security right (its effectiveness as between the parties) and registration are completely independent acts: registration does not create or evidence the creation of the security right; nor is registration necessary for creation of the security right (see A/CN.9/631, recommendation 34).

32. Whether a security right has actually come into existence cannot be determined from a search of the registry. Existence depends on establishing (by reviewing off-record evidence and documentation) that the parties have concluded a security agreement that satisfies certain formal and essential requirements, and that the grantor has rights in (or the power to encumber) the assets described in the security agreement (see A/CN.9/631, recommendations 12-14). Similarly, the scope of the encumbered assets depends primarily on the description set out in the security agreement, not in the registered notice (if the description in the security agreement covers a narrower range of assets than the description in the registered notice, the description in the security agreement is determinative). Only where the description of encumbered assets in the registered notice is narrower in scope than that in the security agreement, will the extent of third-party effectiveness be controlled by the description in the registered notice.

(c) Registration insufficient for third-party effectiveness

33. An important consequence of a "notice-filing" system of the type recommended in this Guide is that the registration is no guarantee of the actual existence of a security right. In other words, unlike traditional approaches to registration in many States, "notice" registration does not prove the existence of the security right. This means that registration by itself does not result in third-party effectiveness of the right described in the notice. That status is acquired only if and when the requirements for creation of a security right are also satisfied (see A/CN.9/631, recommendation 33).

34. There are two implications of this approach to registration, which increase the flexibility and efficiency of the secured transactions system. First, while creation is a prerequisite to third-party effectiveness, it need not precede registration. As explained in chapter VI (see A/CN.9/631/Add.3, paras. 73-75), a notice of a security right may be registered either before or after a security agreement is concluded. Second, while a security right covering after-acquired assets (i.e. acquired after the

creation of the security right) comes into existence in respect of those assets only as they are acquired, it is possible to register of a notice describing them as potentially encumbered assets.

35. While it is often the case that no great consequences flow from differences in the order in which these two steps to achieve third-party effectiveness (i.e. creation of a security right and registration), this is not always true. The time of creation is important, if a third party acquires rights in assets described in a registered notice (for example, by gift or sale or as a result of insolvency or judgement enforcement proceedings) after registration takes place. If the requirements for creation have also been satisfied by the time a third party acquires rights in encumbered assets, the security right will be effective against the third party and its priority will be determined according to the rules set out in chapter VII (see A/CN.9/631/Add.4). However, if the conditions for creation have not yet been satisfied, the third party will acquire the asset free of the subsequently created security right, notwithstanding that it has searched the registry and is aware of the notice filed by the secured creditor. Until both creation and registration have occurred, third-party effectiveness is not achieved.

36. The principle that third-party effectiveness dates from the time both requirements are met, and not necessarily from the time of registration, is subject to one important exception. As a general rule, in order to promote certainty and transparency among secured creditors, priority among competing security rights that have been made effective against third parties by registration is made to depend on the order of registration, not the time of creation (see A/CN.9/631, recommendation 78). That is, as between two secured creditors, one of which has registered first, but created its security right after the other has both created its security right and registered a notice, the first register will have priority.

(d) Extension of registry system to other transactions

37. The establishment of a general and comprehensive security rights registry system of the kind contemplated by this Guide enables searchers to discover potential encumbrances on a grantor's assets and to take steps to protect their rights. States that have adopted these types of registries have also tended to expand their scope. That is, these States have concluded that, even though the primary purpose of the registry is to serve as a repository of information about potential security rights, it can also serve to record information about other types of non-possessory rights in movable property. The registries have been extended to embrace registration of a wide variety of notices indicating that a non-possessory right exists, or that some other intangible right may exist in favour of a third party.

38. The idea of using a security rights registry for other purposes is not novel. Many States that have established specialized registries to record the pledge, hypothecation, mortgaging or assignment by way of security of claims to payment (for example, a right to an insurance payment, or commercial receivables) also provide that the outright assignment of an individual payment claim, or an entire category of payment claims may (and in some cases, must) be registered in the specialized registry in the same manner as if it were a security right. Typically, in States that have adopted comprehensive security rights registries, registration is mandatory in the sense, in the absence of registration or completion of another third-party effectiveness step, the security right is not effective against third parties (in

other words, registration is non-mandatory in the sense that its absence does not affect the effectiveness of the security right as between the parties). An outright assignee of receivables is subject to the same registration requirements for third-party effectiveness and the same priority rules that apply to the holder of a security right in receivables. The rationale is that there is little practical difference, from the perspective of the rights of third parties, between an outright assignment and a security assignment and that, consequently, the rules for effectiveness against third parties of both types of transaction should be the same. This is the approach recommended by this Guide (see A/CN.9/631, recommendation 33).

39. In general, States have not sought to require owners of movable property to register their ownership. So, for example, while many States either require or enable the registration of leases of immovable property, only a few extend this idea to movable property. Nonetheless, States that have established a general security rights registry tend also to make registration in this registry a condition for the third-party effectiveness of transactions where there is a disjuncture between the owner and the person that, over a period of time, has possession of an item of movable property and appears to use it as if it were an owner. The two most common situations involve true leases of significant duration (for example, one year or longer) and commercial consignments in which the consignee is in possession of inventory as an agent for sale on behalf of the owner. In States that adopt this approach, the rights of the lessor and the consignor against third parties are subject to the same third-party effectiveness and priority rules that apply to the holder of an acquisition security right. The rationale for this approach is that in the absence of registration, third parties dealing with the lessee's or consignee's business assets have no objective means of determining whether they belong to the lessee or consignee or to a lessor or consignor.

40. The extension of the registration requirements for security rights to true leases is reflected at the international level in the Convention on International Interests in Mobile Equipment, which extends the scope of the international registry contemplated by the Convention beyond security rights and financial leases to include leasing arrangements.

41. Many States have long known of the concept of a judicial hypothec, under which a judgement creditor may register the judgement for a sum of money against the immovable property of a judgement debtor, and thereby obtain a security right in that immovable property. As the concept of a registrable non-possessory security right in movable property developed, some States began to permit the registration of judgements against movable property. States that have adopted a general security rights registry tend to provide for registration of a notice of a judgement indexed according to the identity of the judgement debtor. In States that adopt this approach, registration creates the equivalent of a security right in the movable property of the judgement debtor in favour of the judgement creditor. This approach can indirectly promote the prompt voluntary satisfaction of judgement debts, since third parties will be reluctant to buy or take a security right in the encumbered assets until the judgement debtor has paid the judgement debt and brought about a termination of the registration.

42. In States that adopt this approach, the judgement debtor's insolvency representative is typically entitled to claim the monetary benefit of a registered judgement creditor's priority for the benefit of all unsecured creditors (sometimes

subject to a special privilege in favour of the registered judgement creditor to compensate for expenses and efforts). The purpose of this rule is to ensure that the registered judgement creditor's rights do not conflict with insolvency policies requiring equality of treatment among the debtor's unsecured creditors. The Guide does not make a recommendation on this point, since it is an issue for law other than secured transactions law (as to the priority between a secured creditor and a judgement creditor, see A/CN.9/631, recommendation 90).

3. Possession

(a) General

43. In virtually all States, a transfer of possession of tangible assets to the secured creditor (the classic possessory pledge) is accepted as sufficient to both evidence the creation of a security right and make it effective against third parties. At the level of creation, this is based on the theory that the transfer of possession evidences the grantor's implicit consent to the security right and the scope of the assets encumbered by that security right. At the level of third-party effectiveness, while a transfer of possession does not positively publicize the existence of a security right (for example, it does not necessarily mean that the person in possession is a pledgee rather than a lessee, a borrower or a mere depositary), it does eliminate the risk that third parties will be misled by the grantor's possession into thinking that the grantor holds an unencumbered title to the property.

44. While historically possession was often the exclusive method for adverting third-parties to the existence of a security right, over the twentieth century many States also developed specialized registries for certain categories of movable property. For example, some States created registers for non-possessory pledges of commercial or industrial equipment. The existence of a register for non-possessory commercial pledges was not, however, accompanied by a general prohibition on the "true" pledge of this type of asset. As a result, it was often possible that competing possessory and registered security rights could encumber the same asset. A similar result is possible in States that have established general security rights registries. Registration of a notice in a registry system for security rights is seen as an alternative method for achieving third-party effectiveness that co-exists with specialized registration systems or grantor dispossession.

45. The idea of maintaining the approach that contemplates the co-existence of these methods of achieving third-party effectiveness is not without controversy. Two intertwined rationales are advanced for abolishing possession as a method for achieving third-party effectiveness wherever a general security rights registry exists. The first is that possession detracts from the reliability of the registry record as a comprehensive source of information about the potential existence of security rights in a grantor's assets. Prospective secured creditors or buyers cannot rely on a negative search of the registry to conclude that the relevant asset is unencumbered. They must also verify that the asset is in the grantor's possession. The second rationale relates to difficulties of proof. Whereas the registry offers a reliable public record of the relevant time for establishing priority between a security right and the right of a competing claimant, possession requires potentially contested evidence of when the physical transfer of possession actually occurred.

46. Despite these concerns, States that have established general security rights registries invariably also retain transfer of possession as an equally valid alternative method for achieving third-party effectiveness of a security right in tangible property. The reasons for doing so are several. The sufficiency of possession for third-party effectiveness is well established in commercial practice. Moreover, transfer of possession as a method of third-party effectiveness would need to remain available in any event for negotiable documents and negotiable instruments in order to preserve their negotiability and the associated priority. As for the intrusion on the comprehensiveness of the registry record, a prospective secured creditor or buyer will usually need to verify whether the relevant assets actually exist and, for this purpose, it will typically be required to verify the grantor's continued possession. Similarly, evidentiary problems relating to the time of the transfer are unlikely to pose difficulties in practice. In its own self-interest, a prudent secured creditor will want to ensure that the time at which it acquired possession is well documented.

47. States that maintain both registration and creditor possession as methods for achieving third-party effectiveness also adopt the principle that, except in very limited cases, these two methods produce exactly the same consequences (both as to the time at which the security right actually becomes effective against third parties, and as to the priority consequences attaching to these additional steps). This said, however, as a practical matter these are not equal methods for achieving third-party effectiveness. First, transfer of possession is an available method of third-party effectiveness only if the asset in question may actually be possessed (that is, is a corporeal, tangible asset). Second, transfer of possession is viable only where the grantor is prepared to give up ongoing use and enjoyment of the encumbered assets. It is not feasible if the grantor needs to retain the encumbered assets in order to produce its services or products or otherwise generate income.

48. For these two reasons, once a comprehensive and efficient notice registration system becomes available, the vast majority of secured creditors tend to prefer registration to possession as a method for achieving third-party effectiveness. The two main exceptions are transaction-specific and usually involve short-term financing. So, for example, where possession confers a priority advantage, as in the case of negotiable instruments and negotiable documents, secured creditors will take possession even if they or any other party may have already registered a security right (see A/CN.9/631, recommendations 99 and 107). In addition, where the secured creditor is in the business of taking possessory security rights (as is the case with pawnbrokers) it is rare that it will also register its security right. Given that the possessory pledge is well-known and well-understood in most States, that there can be efficiencies in permitting possession as a method for achieving third-party effectiveness, and that the disruptions to the integrity of the registry are not significant, this Guide follows the position of those States that have adopted a general security rights registry and endorses both registration of a notice and transfer of possession to the secured creditor as a method for achieving third-party effectiveness (see A/CN.9/631, recommendation 38).

(b) Constructive possession insufficient

49. While the pledge originated in the actual transfer of a specific item of tangible property from the grantor (pledgor) to the secured creditor (pledgee), over time States sometimes relaxed the rules as to what might constitute creditor possession.

In some States, constructive possession (for example, an agreement appointing the grantor as the secured creditor's agent) is now accepted as sufficient to constitute and give third-party effectiveness to a security right in tangible property. In other States, possession may be symbolic, as when a grantor affixes a notice to an object or to the door of an establishment stating that the object or contents of the establishment have been pledged to the secured creditor. These developments were usually the result of an absence of a more general mechanism for creating a non-possessory pledge (or security right) in movable property. This said, some States that today do not permit non-possessory security rights maintain a strict requirement that the creditor's possession be real: public, continuous, peaceful and unequivocal (for a discussion of possession as condition of creating a possessory security right, see A/CN.9/631/Add.1, paras. …).

50. States that have established a general security rights registry and that continue to allow creditor possession as a method of third-party notice invariably adopt the strict approach to possession. Creditor possession requires real relinquishment by the grantor of physical control over the encumbered assets. Continued possession by the grantor or anybody closely associated with the grantor would not provide a sufficient signal to third parties that the grantor's title is potentially encumbered. That is, because the existence of a security rights registry enables debtor-in-possession security, there is no need to relax the concept of possession to facilitate the creation of security rights. This is also the approach recommended by the Guide and its rationale (for the definition of "possession", see A/CN.9/631/Add.1, para. 9).

(c) Possession by a third party

51. It is widely accepted, regardless of whether a State has established a general security rights registry, that possession need not involve direct custody by the secured creditor. Possession by an agent or representative of the secured creditor is sufficient to possession by the secured creditor, provided that an objective bystander would not conclude that the encumbered assets remain in the grantor's possession. There are various means by which third-party possession may be effected.

52. In some cases, the secured creditor has neither the capacity nor the expertise to properly safeguard encumbered assets. Here, a depositary acting for the secured creditor will typically take or receive possession in the secured creditor's name. In other cases, the encumbered assets may already be in the custody of a third party at the time the security right is created. For example, these assets may be diamonds, gold, jewellery or other precious metals in the safe keeping of a security company. In these cases, it is necessary for the holder to be informed that the grantor has pledged the property, and that until receipt of a notice from the secured creditor it may not release the property to the grantor.

53. More commonly, existing third-party custody arises because a third-party carrier or warehouse-keeper holds the encumbered asset. Here, a form of third-party effectiveness through possession can occur when the third party issues a receipt in the name of the secured creditor or agrees to hold the encumbered assets on behalf of the secured creditor. In this case, the third party's actions confirm that it is in possession on behalf the secured creditor.

54. Alternatively, if the document of title is issued in negotiable form, this means the carrier or warehouse keeper is obligated to deliver the assets represented by the

document to the person currently in possession of it. Delivery of the document with any necessary endorsement to the secured creditor therefore offers an alternative means of achieving third-party effectiveness of a security right in the assets it represents.

55. In some States, the idea of third-party possession by a depositary or warehouse-keeper has been extended to ad hoc arrangements between the parties. That is, in these States, a transfer of possession to the secured creditor's agent need not even require physical removal of the encumbered assets from the grantor's premises. In "field warehousing" arrangements, for example, a representative of the secured creditor (typically an employee of the grantor) takes physical custody of the encumbered assets on the grantor's premises (for example by placing them in a locked store room to which only the representative has the key). Any release of the assets in the "field warehouse" to the grantor requires the consent of the secured creditor.

56. Field-warehousing arrangements are most common in States in which the possessory pledge is the only available form of security in movable property. Nonetheless, even in States that offer the alternative of a public registry, a secured creditor may still wish to engage in field warehousing as a practical monitoring technique. However, it will generally also register a notice of its security right to ensure real certainty with respect to third-party effectiveness and to avoid the risk that the arrangement will be challenged as involving constructive rather than real possession.

57. In States that maintain creditor possession as a method for achieving third-party effectiveness, the possibility that this creditor possession may be exercised through the custody of an agent or representative is an important feature of modern regimes of security rights. It enhances the efficiency and effectiveness of possessory security rights, while lowering its cost by permitting creditors to delegate custodial responsibility to experts. For these reasons, this Guide foresees that creditor possession may be effected through third-party custody (see definition of "possession" in A/CN.9/631/Add.1, para. 19).

(d) Inapplicability of possession to intangible assets

58. Underlying the idea of possession as a possible method of achieving third-party effectiveness is the idea that physical custody of an asset is transparent. This is why, both historically and today, States that authorize security through pledge agreements require the encumbered assets to be tangible property. Intangible assets are excluded because it is not physically possible to take possession of an intangible asset. Very often, a creditor seeks to take a security right in the grantor's receivables, but cannot achieve third-party effectiveness of its security right by possession. Only if the receivables are made corporeal in a negotiable instrument can creditor possession constitute a method for achieving third-party effectiveness. A deposit certificate or other instrument that merely evidences a debt, but that is not negotiable, cannot be the subject of "possession". Likewise, should a grantor seek to create a security right in a lease of a piece of equipment, it could not achieve third-party effectiveness by handing over either the equipment (which it does not own) or the lease contract to the secured creditor.

(e) Adequacy of possession for the purposes of enforcement

59. Not all secured creditors will immediately seek to achieve third-party effectiveness of a security right. For whatever reason, they may neither register a notice in the general security rights registry, nor take possession of the encumbered assets. In States that consider the pledge to be a property contract, the absence of creditor possession means that the pledge is never constituted, even as between the parties. In other States, most commonly those that have adopted a general security rights registry but that also provide for creditor possession as a method for achieving third-party effectiveness, the pledge may be constituted between the parties even without creditor possession. In these cases, it is necessary to determine the conditions under which subsequent actual creditor possession will constitute a method for achieving third-party effectiveness.

60. In some States, a security right is not made effective against third parties by possession when possession results from seizure by the secured creditor as a result of the grantor's default. This approach has both a conceptual and policy rationale. Conceptually, the voluntary surrender of possession by the grantor to the secured creditor at the outset of the secured transaction involves recognition by both parties that the secured creditor's rights are to be protected in this way. Seizure for the purposes of enforcement usually involves the involuntary taking of the encumbered asset from the grantor as a result of the grantor's default. Moreover, even where the grantor voluntarily surrenders the asset, it does so under the coercive threat of enforcement proceedings. The policy rationale rests on the fact that seizure for enforcement purposes typically will be relied upon by a secured creditor that has failed to register notice of its security right or has failed to register it properly. Particularly in the context of a competition with the grantor's insolvency representative, there are concerns that recognition of seizure as a sufficient act of third-party effectiveness would reward imprudent conduct, encourage precipitous enforcement action, and involve difficult questions of proof as to whether the seizure occurred before or after the commencement of the insolvency proceedings.

61. In other States, by contrast, the motivation and context of creditor possession is held not to be relevant to determining its consequences. Creditor possession results in third-party effectiveness even when the secured creditor obtains possession through seizure of the encumbered assets for the purposes of enforcement. This approach is based on the theory that the function of possession is to ensure that third parties are not prejudiced by the grantor's remaining in possession of assets to which it does not hold unencumbered title. Possession by the secured creditor serves this goal regardless of the motive for taking possession. Because the primary context in which this policy issue arises involves a competition between the secured creditor and the grantor's insolvency representative, this Guide does not contain a recommendation on the point, but defers to a State's insolvency regime.

4. Registration in a specialized registry or notation on a title certificate

(a) General

62. The two main approaches to achieving third-party effectiveness just reviewed (registration in a general security rights registry and creditor possession) presuppose that the central objective is to alert third parties to the possible existence of a security right. Even in States that heretofore have established fragmented registries,

that is, registries in which the organizational structure focuses on the type of transaction (for example, retention-of-title, or commercial pledge registries), or the status of the grantor (for example, corporation registries), or the identity of the secured creditor (for example, banks), or the type of encumbered assets (for example, equipment or receivables registries), the focus of the registry is on security rights. Only by exception are these registries open for registrations that are not, or not intended as, security rights (for example, outright assignments of receiveables, long-term leases, commercial consignments).

63. In many States, however, there have traditionally existed other forms of publicizing rights. On occasion, a specialized, asset-specific registry may be established to record all transactions related to that type of asset. The model for these types of registry is the standard register of rights in immovable property, in which title, encumbrances, public charges and even caveats about impending litigation can often be registered. States also create systems where certain types of movable property are identified by a title certificate, and various transactions relating to that property (including security rights) may be directly noted on the title certificate. The common features of these two approaches to publicizing rights are that (i) the mechanism in question is created only in respect of certain, identified assets and (ii) all types of rights (and not just security rights) may be recorded and publicized. These mechanisms have proved their usefulness over time, such that even in States that have established general security rights registries, they are often maintained as alternative methods to registration and creditor possession for achieving third-party effectiveness.

(b) Registration in a specialized movable property registry

64. As noted, a general security rights registry in which parties may register a notice about a potential or existing security right can be an effective way of alerting third parties to the need to verify carefully the status of a grantor's rights in the movable property with which it proposes to deal. However, sometimes a specialized registry for particular assets can be just as operationally efficient while also serving important broader functions that cannot be replicated by a general security rights registry. For example, ship and aircraft registries are two widely recognized instances where a specialized registry functions to address international regulatory concerns about safety and national concerns of State security in addition to facilitating commercial transactions.

65. For these reasons, many States recognize that registration in a specialized registry already existing under other law may be an alternative method of achieving third-party effectiveness for security rights in assets covered by the regime (see A/CN.9/631, recommendation 39). Typically, the logistics of registration in a specialized title registry are not addressed in secured transactions laws, since this is a matter for the specialized law governing that regime. Frequently, the existing system requires, in the manner of many security rights registers that developed in the nineteenth and twentieth centuries, the registration of the security documentation, or the registration of a summary of that documentation that is certified by the registrar. The rationale for adopting a "notice-filing" approach in the case of a general security rights registry should equally apply to these specialized asset registries. States maintaining such registries might, therefore consider whether

they should adopt a notice system as a complementary reform aimed at enhancing the efficiency of the registry.

66. Registration of a notice about a security right in principle can be made available even in registry systems that function first and foremost as title registries. In the case of a transfer of ownership, these registries typically require evidence of the underlying transfer documentation, since registration of an unauthorized transfer may prejudice a secured creditor or purchaser that relies on the ownership registry record. However, the same level of proof is unnecessary for security rights, since a registry search that discloses a security right when none in fact exists has no detrimental effect in itself. Potential purchasers and secured creditors can protect themselves by refusing to purchase or to lend except on terms that take account of the registered security right with the result that the grantor will take action to have any of (i) an unauthorized registration, (ii) a continuing registration after the secured obligation has been paid, or (iii) a registration in respect of which no security agreement was ever executed, expunged from the record.

67. States that maintain specialized registries must determine whether registration in the specialized registry will be the exclusive method of achieving third-party effectiveness of security rights over the assets covered by it. Some States take this position. No rights in the asset may be claimed as against third parties if notice of those rights in not given in the specialized registry. Other States adopt a less absolute position and permit alternative methods for achieving third-party effectiveness of security rights in assets covered by the specialized registry. In these States, the rationale is that, with the exception of competing claimants whose rights are sought to be protected by the specialized title regime and that have prejudicially relied on the register, there is no reason why third-party effectiveness against all other claimants could not be achieved by other generally available methods. It follows that the secured creditor should also be permitted to make its security right effective against third parties by registration in the general security rights registry or by a transfer of possession of the encumbered assets.

68. It is important to be clear about the scope of the stated exception for actual detrimental reliance. The idea is that, even though the security right is effective against third parties, its priority when made effective by one of these other methods is subordinated to competing secured creditors and buyers that register their rights in the specialized registry. The subordination exists regardless of the respective time of the registration in the two registries. This approach enables a secured creditor that takes a security right in all of the grantor's movable assets, or in generic categories of them, to protect itself against the grantor's insolvency representative or judgement creditors by making a single registration in the general security rights registry. Registration in the specialized registry is necessary only if the secured creditor concludes that the risk of an unauthorized grant of security to a competing secured creditor or sale to a buyer that registers in the specialized registry is sufficiently high to warrant the burden of making an additional registration in the specialized registry. In view of the limited number of these specialized registries and the types of assets they envision, the creation of a superior priority right to those that use the specialized registry does not significantly compromise the efficiency and integrity of the general security rights registry. For these reasons, the Guide recommends that, where specialized registries are maintained, third-party effectiveness may nonetheless be achieved by alternative methods such as

registration in the general registry or creditor possession, subject to protecting the superior priority position of registrants in the specialized registry (see A/CN.9/631, recommendations 39, 83-84).

(c) Notation on a title certificate

69. Although most States have registration systems for the ownership and the transfer of ownership of motor vehicles and similar assets, these registry systems are generally not treated as establishing ownership for the purposes of commercial transactions and for that reason are not searchable by the public. Rather their purpose is primarily regulatory, namely to enable the authorities to trace ownership in the event of an accident, or breach of criminal or safety standards and to allocate compulsory insurance liabilities and obligations.

70. These regimes usually provide the owner with a certificate of registration and a sale of the vehicle is invariably accompanied by the relinquishment of the old certificate to the appropriate regulatory authority and the issuance of a new certificate in the name of the new owner. In some States, notably those that have not established a general security rights registry, the title registration certificate is deployed as a basis for publicizing security rights in the asset represented by the registration certificate. In these States, a notation of the security right on the face of the certificate is treated as sufficient for third-party effectiveness of the indicated security right.

71. In States where this kind of certificate notation system is already in place and appears to be working well in practice, there may be little reason to abolish the system when a modernized regime of security rights is put into place. Nonetheless, it will be necessary to address the interrelationship of the existing system to the other methods of third-party effectiveness permitted under a new regime. Typically, notation on a title certificate is a sufficient method for obtaining third-party effectiveness of a security right in a tangible asset subject to the system. Registration in the general security rights registry and the taking of possession by the creditor are two other methods. However, if either of these latter methods is used, the priority of the security right to which they relate will be subordinated to the rights of a competing buyer or secured creditor that has relied on the certificate notation system. As with the approach taken to registration in a specialized title registry, this approach is intended to protect the reliability of and integrity of the title certificate system while enhancing the flexibility and efficiency of the general secured transactions system. The Guide recommends this approach (see A/CN.9/631, recommendations 39, 83 and 84).

5. Automatic third-party effectiveness of a security right in proceeds

72. It is inherent in the nature of movable property that it may be sold and re-sold during the period when the secured credit remains unpaid but not in default. The sale or other disposition of secured assets will normally give rise to proceeds (for the definition of “proceeds”, see A/CN.9/631/Add.1, para. 19), whether in the form of cash, negotiable instruments, receivables, other property received in exchange, or some combination of all of the above. In many States, a security right in any proceeds (including proceeds of proceeds) derived from the originally encumbered assets is automatically created as soon as these proceeds arise provided they remain identifiable. This is the approach recommended in this Guide (see A/CN.9/631,

recommendation 18). However, this is not the only question that needs to be addressed. It is also necessary to determine whether the secured creditor should have to register or take some other step to make the security right in the proceeds effective against third parties.

73. While notices registered in a general security rights registry are organized and indexed by reference to the identity of the grantor, the registered notice must set out a description of the encumbered assets (see A/CN.9/631, recommendations 58 and 64). Thus, it is necessary to first distinguish the situation where the security right in the originally encumbered assets was made effective against third parties by registration and the proceeds are of a kind that falls within the description in the registered notice. For example, if the registered notice describes the encumbered assets as "all present and after-acquired tangible property" and the grantor sells a farm tractor and uses the proceeds to purchase a sailing yacht, the description in the registered notice includes the proceeds as originally encumbered assets in the form of after-acquired tangible property. As registration may be made in advance of the creation of a security right, in principle the original registration is sufficient to give third-party effectiveness to the security right subsequently created in the proceeds when they arise. Most States that provide for an automatic right in proceeds also provide for automatic third-party effectiveness in these cases, and this is the result that is recommended in this Guide (see A/CN.9/631, recommendation 40).

74. More difficult questions arise when the security right in the originally encumbered assets is made effective against third parties by means of a notice in which the description would not point to the assets received as proceeds or by a method that would be insufficient if the proceeds were originally encumbered assets. In the above-mentioned example, to consider the first case, if the registered notice described the originally encumbered assets as "all present and after acquired farm equipment", this description would not cover the sailing yacht. As for the second case, if the originally encumbered asset is a right to payment of funds credited to a bank account made effective against third parties by control, and the grantor withdraws funds without authority to purchase a sailing yacht, the method of third-party effectiveness used for the originally encumbered assets would not be sufficient for the proceeds.

75. These examples raise competing policy considerations. To give automatic third-party effectiveness to the security right in the proceeds undermines the policy underlying the third-party effectiveness requirements, since third parties would not be alerted to the potential existence of the security right in the proceeds. After all, a prospective purchaser of a sailing yacht from the grantor will not necessarily appreciate that a registered notice referring to a security right in farm equipment also covers the sailing yacht as proceeds. On the other hand, to require the secured creditor to take immediate steps to make the security right in the proceeds effective against third parties may impose an excessive monitoring burden and priority risk. The proceeds will often have arisen as a result of the grantor's unauthorized dealing with the originally encumbered assets. In such cases, the secured creditor will usually not become aware of the unauthorized disposition until well after the fact. If the disposition were, in fact, unauthorized, the secured creditor would generally be entitled to follow the originally encumbered asset into the hands of a transferee, and would therefore not suffer any prejudice. However, it may not always be possible after the fact to locate the asset or the transferee, and in some cases the amount of

the proceeds received might actually be higher than the value of the assets at the time it becomes necessary to enforce the security right.

76. In seeking to achieve a reasonable balance between these competing policies, most States that provide for an automatic creditor right in identifiable proceeds typically treat a security right in proceeds that would not be covered by the initial description of the encumbered assets as automatically effective against third parties, either permanently or only for a temporary period. The extent and duration of third-party effectiveness in these States depends on the nature of the initially encumbered assets and the nature of the proceeds.

77. Permanent third-party effectiveness is given to a security right in proceeds that take the form of money, receivables, negotiable instruments and rights to payment of funds credited to a bank account (for the definitions of these terms, see A/CN.9/631/Add.1, para. 19). This approach is based on the idea that the absence of an independent act of third-party effectiveness for these types of proceeds does not pose any significant risk of prejudicial reliance for third parties. In the case of money and negotiable instruments, this is because subsequent transferees or secured creditors that take possession generally take free of a security right in any event (see A/CN.9/631, recommendations 99 and 104). As money and negotiable instruments are typically derived by the grantor from the collection of receivables (proceeds of proceeds), it would be illogical and counterproductive to not extend automatic third-party effectiveness to the original proceeds, the receivables. Money and negotiable instruments collected from receivables are typically then credited to the grantor's bank account (proceeds of proceeds of proceeds). A transferee of funds from the account generally takes free of any security right so the absence of publicity does not prejudice their rights (see A/CN.9/631, recommendation 103). As for secured creditors and assignees that take security in the right to payment of the funds in the account, the Guide recommends that priority be given to a secured creditor that achieves third-party effectiveness by control and to the depository bank's right of set off (see A/CN.9/631, recommendations 101-102). Consequently, with respect to these types of asset, competing claimants must be taken to know that they risk subordination in any event unless they protect themselves by assuming control of the account. Given these considerations, in order to ensure the coherence of the regime governing proceeds in the form of money, receivables, negotiable instruments and rights to payment of funds credited to a bank account, most States provide that permanent third-party effectiveness in these assets is automatic. It is also the result recommended in this Guide (see A/CN.9/631, recommendation 40).

78. For other types of proceeds, a different set of policies are in play. It may well be that the disposition giving rise to the proceeds is unauthorized and that the creditor does not quickly become aware of the disposition. Hence, it is reasonable to provide that the security right is automatically effective against third parties. However, by contrast with money and money-like proceeds, proceeds that take the form of tangible assets appear to third parties as property of the grantor. Where they do not fall within the initial description therefore, third parties can easily be misled. For this reason, and in order to avoid unduly undermining the rights of third parties, most States provide that the automatic third-party effectiveness will last only for a short period of time after the proceeds arise. To achieve permanent third-party effectiveness, the secured creditor must register a notice or otherwise take positive steps to make the security right effective against third parties before the expiry of

that period. Obviously, the temporary period must be relatively short and yet not so short as to deprive a reasonably prudent secured creditor from the opportunity to take steps to preserve the third-party effectiveness of its security right. A period of twenty to thirty days seems to be the compromise that most States find acceptable. This Guide adopts the logic of a short temporary automatic third-party effectiveness period within which the secured creditor must amend the description of secured assets so as to cover proceeds of a type different from the assets initially encumbered (see A/CN.9/631, recommendation 41).

6. Third-party effectiveness of a security right in attachments

(a) General

79. An asset encumbered by a security right that has been made effective against third parties may be attached, or may become attached, to other property (whether movable or immovable). For example, tires subject to a security right may later be attached to a truck, or a heating boiler subject to security right may later be attached to a building. In some States, attachment terminates the security right. This approach is based on policy concerns about protecting the position of buyers and other third parties that subsequently acquire rights in the property to which the encumbered asset is attached. In other States, only attachment to immovable property will terminate an existing security right in movable property that becomes an attachment. The policy in these States is to prevent subsequent detachment, and consequential deterioration of the immovable property while also preserving the priority of the rights of any creditor that has taken security over the immovable property prior to the attachment.

80. States that have adopted a comprehensive registry system for movable property resolve these policy concerns more directly by seeking a balance between competing rights. Most regimes are organized so as to permit the security right to survive attachment at least as between the parties. However, in order to address the respective rights of the secured creditor and third parties, these regimes also provide a full set of third-party effectiveness and priority rules. This is the general approach adopted by this Guide. Thus, chapter IV (see A/CN.9/631/Add.1) confirms that a security right may be created in tangible property that is an existing attachment, or that becomes an attachment subsequently, to the extent of the value of the tangible at the time of its attachment (see A/CN.9/631, recommendation 22). This chapter addresses the issue of third-party effectiveness, while chapter VII (see A/CN.9/631/Add.4) deals with priority.

(b) Attachments to movable property

81. If the tangible property subject to the security right is attached to other tangible property (that is, another movable object), the general requirements for third-party effectiveness apply. Attachments are not singled out for special treatment. Thus, if the security right is made effective against third parties by registration prior to attachment, it remains effective after attachment without the need for any further step (see A/CN.9/631, recommendation 42). This is because, unlike the situation where the originally encumbered asset is replaced by proceeds, attachments retain their discrete identity after they are attached to other property. Consequently, it is reasonable to assume that a third party that searches the registry for security rights in the property to which the attachment is attached (for example, an automobile)

will understand that a registered notice that describes the attachment (for example, automobile tires) may refer to the tires installed on the automobile in which the third party is interested.

82. Theoretically, a security right in an attachment would also remain effective against third parties if the security right had been made effective prior to attachment by a transfer of possession to the secured creditor or to a third party agent of the creditor rather than by registration in the general security rights registry. However, as a practical matter, third-party effectiveness will typically cease upon attachment, since the secured creditor will normally have to relinquish possession to allow the attachment to take place. Consequently, third parties that deal with the asset after attachment will take free of the security right, unless the secured creditor preserves its status by registering in the general security rights registry before giving up possession or before their rights arise. By contrast, if the secured creditor is also in possession of the movable property to which the attachment is made, or if an agent or representative of the creditor has possession of that property, third party-effectiveness is preserved (however, this will not be the usual case).

(c) Attachments to immovable property

83. If the encumbered asset is attached to immovable property, the policy considerations are more complex. This is because any rights that charge the immovable property will normally be registered in the immovable property registry. As between the parties, this Guide recommends that a security right in an attachment to immovable property may be created according to the principles elaborated in this Guide, or according to the regime governing rights in the immovable property. Consistently with this idea, the security right so created may be made effective against third parties either by registration in the general security rights registry or by registration in the immovable property registry (see A/CN.9/631, recommendation 43). However, if a security right is created under the regime governing movable property and the requirements for creation are not sufficient for creation under the regime governing immovable property, the rules governing the immovable property registry would have to be modified to nonetheless permit registration of the security right in the attachment. Moreover, the choice of method has priority consequences. Registration in the immovable property registry is necessary to achieve maximum protection against third parties. A secured creditor or buyer that registers in the immovable property registry has priority over a secured creditor that relies on registration in the general security rights registry (see A/CN.9/631, recommendation 93).

84. This special priority rule is necessary to preserve the reliability and integrity of the immovable property registry. It is workable only if registration of a security right in an attachment in the immovable property registry can be done easily and efficiently. The existing immovable property registry systems may require the submission of full security documentation or impose other formalities for registering security rights. If this is the case, land registration laws may need to be revised to authorize registration of a notice of a security right. Otherwise, the cost and expense involved in fully protecting their priority status by registering in the immovable property registry may deter secured creditors from engaging in secured financing that involves attachments to immovable property.

(d) Attachments to movable property subject to a specialized registry

85. It is quite common, in those States that have specialized title registries that the types of property subject to registration in these registries involve property to which other tangible property is normally attached (e.g. ships, aircraft, road vehicles). Because of the desire to protect the integrity of the special registry, States usually adapt the approach to a security right in tangible property that is attached to immovable property to the case of attachments to tangible property subject to a specialized title registry or title certificate system. The security right may be made effective against third parties either by registration in the general security rights registry or by the creditor taking possession (although as noted above this will be rare), or by registration in the specialized registry or notation on the title certificate (see A/CN.9/631, recommendation 43). As with attachments to immovable property, registration in the specialized registry, or notation on the title certificate, is necessary to achieve maximum third-party protection. A secured creditor or buyer that relies on the specialized registry system has priority over a secured creditor that achieves third-party effectiveness by some other method (see A/CN.9/631, recommendation 93). In order to facilitate access to that system, it may be necessary to amend the law governing that system to ensure that the secured creditor can register a simple notice of the security right in the attachment or note it independently on the title certificate as the case may be.

(e) Coordination of registries

86. When States adopt the position that third-party effectiveness of a security right can be achieved by more than one method, they are required to decide whether all such methods produce identical consequences, or whether one or the other method may produce superior consequences. As noted, to preserve the integrity of registries other than the general security rights registry (the immovable property registry or the specialized title registry) registration in these registries gives the secured creditor the maximum priority protection. For this reason, it is invariably in the interest of a creditor that has registered in the general security rights registry to also register a notice in the specialized registry. Rather than requiring the secured creditor to itself effect a separate registration in the immovable property registry or specialized movable property registry, some States have a registry system in which security rights in attachments that are registered in the general security rights registry are automatically forwarded for registration in the other registry. However, since registrations in the immovable property registry system and in specialized movable property registries are indexed according to the asset, not the grantor, a registrant in the general security rights registry would have to provide the registry with the applicable asset description and specify expressly that a notice covering “all tangibles” includes attachments described specifically.

7. Automatic third-party effectiveness of a security right in a mass or product

87. For the reasons set out in chapter IV (see A/CN.9/631/Add.1, paras. …), this Guide recommends that a security right in tangible assets that are later processed or commingled automatically continues in the finished product or commingled mass (see A/CN.9/631, recommendation 23). This recommendation does not, however, speak to whether the security right in the finished product or mass is effective against third parties. Assuming the security right in the component asset was made

effective against third parties prior to the processing or commingling, the policy question is whether the security right that continues in the product or mass should be treated as automatically effective against third parties.

88. In the most common case, the security right in the originally encumbered assets will have been made effective against third parties by registration in the general security rights registry (since this is the only practically available method for inventory in the form of raw materials). It follows that States have to decide whether this initial registration is sufficient to achieve third-party effectiveness of the security right in the product or mass derived from the processing or commingling of the originally encumbered assets.

89. As noted earlier, while notices in a general security rights registry are organized by reference to the identity of the grantor, the registered notice must set out a description of the encumbered assets (see A/CN.9/631, recommendations 58 and 64). Just as in the case in relation to third-party effectiveness of security rights in proceeds of disposition of encumbered assets, a distinction must be drawn based on the manner in which the initially encumbered assets are described. Consider first the situation where the registered notice describes the encumbered assets in a manner that covers both the originally encumbered asset and the resulting product or mass. For example, a registered notice may describe the encumbered assets as "wheat of xyz type or quality" and the grantor's wheat is later commingled with other wheat of this same type or quality. Similarly, a security right may be taken in resin that is later manufactured into chipboard while the secured creditor registers a notice that describes the encumbered assets as "raw materials and finished inventory". In both cases, a third party searcher will be alerted to the possible existence of a security right in the commingled mass or the manufactured product so there can be no policy objection to treating the original registration as sufficient to give third-party effectiveness to the security right that continues in the product or mass. Most States that have adopted a general security rights regime take this automatic third-party effectiveness approach to these types of cases.

90. More difficult policy concerns arise where the registered notice describes the encumbered assets in terms that include only the component but neither the commingled mass nor the finished product. For example, the secured creditor may have registered a notice that describes the encumbered asset as "wheat of xyz type or quality" and the wheat is then irretrievably commingled with a much greater quantity of wheat of "abc type or quality". A third party searching the registry may not be able to discern the extent of the creditor's rights in the commingled mass. An even more complicated situation arises where the secured creditor registers a notice that describes the encumbered asset as "resin" and the resin is later processed into chipboard. Here, a reasonable third party that searches the registry to determine whether there is any security right in the grantor's chipboard may not understand that a notice referring to a security right in resin also extends to chipboard manufactured from the resin.

91. This second situation especially raises competing policy considerations. To give automatic third-party effectiveness to the security right in the chipboard may compromise the policy underlying the third-party effectiveness requirements, since the registered notice does not necessarily alert third-party searchers to the existence of the security right. On the other hand, to require a secured creditor to also include a description of the resulting product or mass in its registered notice may discourage

financing against the security of a grantor's raw materials or lead to the registration of notices containing overly broad descriptions (as in the example given above where the notice refers to "inventory" even though the security right is limited to resin) to the detriment of the grantor's access to secured credit from other sources.

92. In resolving these competing policies, States take different approaches. In some States, the security right is treated as automatically effective against third parties without the need for any further act. This approach is based on the theory that the risk of detrimental reliance by third parties is minimal in practice. Subsequent secured creditors will be sufficiently knowledgeable about the grantor's manufacturing operations to understand that a registered notice that refers to a security right that describes only the component assets also covers any finished product processed from those assets; and subsequent buyers will generally be protected since the finished product or commingled mass will typically constitute inventory sold in the ordinary course of the grantor's business and a buyer in the ordinary course takes free of a security right in any event.

93. In other States, the security right is treated as automatically effective only as against other secured creditors. If the competition is with someone other than another secured creditor (for example, a non-ordinary-course buyer or a judgement creditor or insolvency representative), the security right is ineffective unless a notice that describes the encumbered asset in terms that include the product or mass is registered before these other rights arise. This approach is based on the theory that, unlike the grantor's secured creditors, these other categories of third-party claimants are more likely to be misled by a description in a registered notice that includes only the raw materials and not the finished product into which they are incorporated.

94. The Guide recommends the first of the two approaches just outlined. That is, it recommends that States adopt a rule to the effect that if the security right in the component asset is effective against third parties, the security right in the resulting product is automatically effective against third parties without the need for the secured creditor to take any further step (see A/CN.9/631, recommendation 45). This choice is based on two considerations. First, in practice it is highly unlikely that a finished product or commingled mass will be sold to a buyer outside the ordinary course of business, since these assets will almost invariably form part of the grantor's inventory. Second, unsecured creditors generally do not look to a grantor's inventory for the purposes of satisfying their judgements, since the grantor is more likely to be in a position to pay their claims if it is able to continue selling its inventory in the ordinary course of business.

8. Continued third-party effectiveness of a security right after a change in the location of the asset or the grantor

95. A change of location is inherent in movable property and persons. Sometimes property or persons move to a different location within the same State. Sometimes, they move to a location in a different State. Where third-party effectiveness is achieved by registration in a general security rights registry, the criteria for searching the registry relate to the name of the grantor. Hence a change of physical location within the same State will not compromise a searcher's capacity to determine if a security right has been created, and therefore should have no impact on the continued third-party effectiveness of the security right. This is not the case, however, where the asset or the grantor moves from one State to another.

96. As explained in chapter XIII (see A/CN.9/631/Add.10, paras. 26-27 and 35-40), the law applicable to the third-party effectiveness of security rights is determined by reference to the current location of either the encumbered assets or the grantor depending on the nature of the encumbered assets (see A/CN.9/631, recommendations 202 and 204). This approach is based on the theory that third parties that deal with the encumbered assets following the change of location cannot be expected to undertake an extensive historical investigation into whether the encumbered assets were previously subject to a different law. However, this approach creates significant risks for secured creditors. Third-party effectiveness ceases as soon as the location of the assets changes unless the security right is made effective against third parties under the law of the new location. While the secured creditor can protect itself if it has advance knowledge of the change of location, in the typical situation this will not be the case.

97. In an effort to balance the competing rights of secured creditors and third parties in this situation, some States provide a period of temporary automatic third-party effectiveness following a relocation of the assets within their own borders or the relocation of the grantor to that State. Under this approach, a security right that was made effective against third parties under the law of the previous location is treated under the law of the State to which the grantor or the assets are relocated as automatically effective against third parties for a short period after the relocation. If the security right is made effective against third parties in accordance with the law in the new location of the grantor or the assets before the expiry of this period, it continues to be effective against third parties that acquire rights in the encumbered assets after the relocation, even if these rights were acquired before the pre-existing security right was made effective against third-parties under the law of the new location. If third-party effectiveness in accordance with the law in the new location of the grantor or the assets is not achieved before the expiry of this period, the security right is ineffective against third parties that acquired rights during the short period.

98. The Guide adopts this approach (see A/CN.9/631, recommendation 46), offering a reasonable balance between accommodating the rights of secured creditors and third parties that deal with the grantor or the assets following relocation. On the one hand, the secured creditor is given a reasonable time period to take action to protect its rights. On the other hand, a defined time period enables a third party that acquires rights in the encumbered asset after the relocation to take effective protective measures such as withholding a loan or extension of credit or the purchase price pending the expiry of the short period of automatic third-party effectiveness, since the third party can rely on taking free from any foreign security right not otherwise made effective against third parties before the expiry of that period.

9. Continuity and lapse of third-party effectiveness

99. As already mentioned, most States that have adopted a general security rights registry system as a method of achieving third-party effectiveness also permit alternative methods for achieving third-party effectiveness (e.g. possession by the creditor, the execution of a control agreement respecting funds in a bank account, registration in a specialized registry, notation on a title certificate). Often, a secured creditor may achieve third-party effectiveness using more than one method at the

same time. Moreover, sometimes, a creditor may change the method by which third-party effectiveness is achieved (e.g. a secured creditor that has taken possession may later file a notice of the security in the general security rights registry). Most of these States provide that continuity of third-party effectiveness is preserved, notwithstanding a change in the method of third-party effectiveness, as long as there is no time when the security right is not effective against third parties under one or more method. This is the approach recommended in this Guide (see A/CN.9/631, recommendation 47).

100. Conversely, there can be situations where third-party effectiveness lapses. Consider the case where the requirements for third-party effectiveness under one method no longer apply and the secured creditor does not achieve third-party effectiveness through another permissible method before the time of lapse (e.g. registration may expire or be cancelled or the secured creditor may relinquish possession of the encumbered asset or the circumstances that resulted in automatic third-party effectiveness may no longer prevail, and the secured creditor has not taken steps to achieve third-party effectiveness using another method). In this situation, third-party effectiveness lapses, and would have to re-established after the lapse. States take different approaches to the effect of a lapse and re-establishment.

101. Some States consider that the lapse is fatal to the continuity of the third-party effectiveness and any re-establishment can only produce effects from that moment onward. The policy here is avoid requiring competing claimants having to go behind the registry record in order to determine if a security right ever existed. Other States provide for a grace period within which a lapsed registration may be re-established. In these States, if third-party effectiveness is re-established within a short delay, it will be deemed to have been continuous, and the initial priority of the secured creditor will be maintained, except as against competing claimants that acquired rights in the encumbered assets during the period of the lapse. The policy here is to permit a secured creditor that may have inadvertently let third-party effectiveness lapse to correct its mistake, as long as no third party suffers prejudice as a consequence.

102. In deciding which of these approaches to adopt it is helpful to analyse the general consequences likely to flow from a failure to preserve continuity of third-party effectiveness. Two situations are particularly telling. The first is where a third party (such as a buyer or insolvency representative or judgement creditor) acquires rights in the encumbered assets after a lapse and before third-party effectiveness is re-established. Since the security right was not effective against third parties at the relevant time, these intervening third parties will acquire the encumbered assets free of the security right. Either of the two approaches will produce this result.

103. The second instance of concern arises where the right of a secured creditor, prior to the lapse, had priority over the right of a competing secured creditor. Priority among competing secured creditors, as a general rule, is based on the order of registration or third-party effectiveness (see A/CN.9/631, recommendation 78). On one approach, if third-party effectiveness lapses, priority dates only from the time when it is re-established. The lapsed security right will be subordinated to a competing security right that is registered or made effective against third parties before or during the period of lapse. On the other approach, priority would be re-established as of the initial time as against all secured creditors that registered or made their rights effective as against third parties before the period of lapse, but not

as against secured creditors that registered or made their security right effective as against third-parties during the period of the lapse.

104. The discussion in the preceding paragraph refers to registration as distinct from third-party effectiveness. The reason for this is that registration, unlike the other modes of third-party effectiveness, may precede creation of the security right. While a registered security right cannot become effective against third parties until the requirements for creation are also satisfied, it ranks against competing security rights from the time of registration, not the subsequent time of creation. As a result, the policy considerations addressed apply equally to situations where a notice is registered prior to the creation of a security right, and lapses before the security right is created, third party effectiveness may be re-established.

105. As noted, there are good policy reasons for both approaches. Nonetheless, because the efficient and effective functioning of a general security rights registry depends on the confidence that registrants and searchers have in its integrity, this Guide recommends that the first of the alternatives be adopted. If a registration lapses, or if third-party effectiveness lapses because one method for achieving it is no longer valid before another method is substituted, third-party effectiveness may be re-established, but it takes effect only from that time forward (see A/CN.9/631, recommendation 48).

B. Asset-specific remarks

1. Third-party effectiveness of a security right in a personal or property right securing payment of a receivable, negotiable instrument or any other intangible asset

106. Very often, receivables, negotiable instruments and other intangible assets are secured by a personal or property right (e.g. a personal guarantee or a security right). For example, a grantor in the business of selling goods on credit may have a security right in the goods to secure the buyers' payment obligations. Where the grantor is itself a lender, its customers' payment obligations may be backed up by a personal guarantee from a third party.

107. In most States, accessory personal or property security rights follow automatically the obligation payment of which they secure. That is, should the creditor of a receivable or holder of a negotiable instrument backed by one or more security rights transfer the receivable or negotiable instrument to a third party, the third-party transferee will also benefit from these security rights.

108. The idea that the accessory security rights follow the principal obligation (receivable, negotiable instrument) also generally applies to security rights that may be taken in the receivable or negotiable instrument. So, for example, because the accessory rights automatically follow the principal obligation, if the security right in the receivable or negotiable instrument has been made effective against third parties it should automatically extend to any accessory rights without the grantor or the secured creditor being required to undertake any further act. This result flows from general principles of the law of obligations in most States and is the approach recommended in this Guide (see A/CN.9/631, recommendation 49).

109. Additional policy considerations are present, however, if the personal or property right securing the principal obligation is an independent undertaking, and legal systems take different approaches in this case.

110. In some systems, these rights follow the payment obligation that they secure only if they are transferable and the transfer is made in a separate juridical act. This approach is based on the assumption that accessory rights are expected by parties to be transferred automatically with the obligations they secure but that the very fact of the independence of an independent undertaking means that parties would normally have the contrary expectation. In other States, even independent security and other rights follow the obligation payment of which they secure automatically without a new act. This approach is based on the assumption that the secured creditor will normally request the grantor to transfer all rights securing the grantor's receivable and that simplifying the achievement of that result will save time and cost and thus have a beneficial impact on the availability and the cost of credit.

111. This second approach is also based on the assumption that rights of third-party obligors of independent rights (such as an independent undertaking) may be protected through separate rules. For example, in the case of a security right in the proceeds of a right to payment under an independent undertaking, third-party effectiveness automatically extends to the proceeds under the independent undertaking (i.e. the right to receive payment; see A.CN.9/631/Add.1, para. 19), but does not extend to the right to draw, which is an independent right (recommendation 26, subparagraph (b)). Because of this protection of the obligor under an independent undertaking, there is no reason not to automatically extend the third-party effectiveness of the secured creditor's rights to whatever rights it may claim in respect of the independent undertaking. This second approach is that adopted in this Guide (see A/CN.9/631, recommendation 49).

112. The case of an independent mortgage or hypothecation of an immovable raises other policy issues. In many States, a secured creditor that has made its security in a receivable effective against third parties will automatically be able to benefit from whatever normal mortgage or hypothecation on immovable property that secures the payment of the receivable. In some States, the law of immovable property requires that a notice of the security right be given to the grantor of the mortgage on the land. This Guide recommends automatic extension of the third-party effectiveness (see A/CN.9/631, recommendation 49), although it acknowledges that overriding policies in respect of land law may lead States to follow the second approach.

113. In some States, it is possible to transfer security rights in immovable property separately from the principal obligation that these rights secure. States that permit the creation of these types of independent mortgage do so primarily to facilitate the securitization and transfer of mortgages. Because the specialized financing practices associated with independent mortgages are typically carefully specified in the land law of a State, this Guide recommends that the automatic extension of third-party effectiveness to rights securing the payment of the receivable or negotiable instrument not apply where the right in question is an independent mortgage (see A/CN.9/631, recommendation 49).

2. Third-party effectiveness of a security right in a right to payment of funds credited to a bank account

114. Funds credited to a bank account are an increasingly important asset that grantors may offer as security for a loan or credit. The asset over which security is taken is not, in fact, the bank account itself, but rather the grantor's right to payment of funds credited to the bank account (for the definition of this term, see A/CN.9/631/Add.1, para. 19). States take different approaches to the requirements for third-party effectiveness of a security right in this type of asset. Among States that have not established a comprehensive security rights registry, most simply apply the general rules for achieving third-party effectiveness of security rights in receivables. This usually means registering a notice in a special registry devoted to the assignment of or creation of a security right in receivables, although it may also sometimes involve the secured creditor giving written notice of the security right to the holder of the account. A similar approach, that is, considering the bank to be the debtor of a receivable, is also taken by many States that have established a comprehensive security rights registry. Because the funds in the bank account are not an identifiable species, the secured creditor can neither take possession itself, nor constitute the bank as its agent. Consequently, registration in the general security rights registry is the exclusive method for achieving third-party effectiveness.

115. Other States with general security rights registries have recently devised a specialized set of third-party effectiveness rules based on the assumption of "control" with respect to the account (for the definition of "control", see A/CN.9/631/Add.1, para. 19). If the secured creditor is the depositary bank, control (and third-party effectiveness) is automatic. Other secured creditors can obtain control in either of two ways. One is for the secured creditor to replace the grantor as the bank's customer on the account. While this creates the functional equivalent of the classic possessory pledge, it is impractical for the grantor's checking and other current accounts to which it needs free access in the ordinary course of business. Consequently, the other variant, a "control agreement", is the method mostly used in practice. Control is achieved through an agreement among the grantor, the secured creditor and the bank. As with automatic control by the depositary bank, a control agreement does not necessarily result in a blocking of the funds. Control (and therefore third-party effectiveness), is achieved even when the grantor remains free to draw on the account until notified otherwise.

116. Under both general approaches (e.g. treating the right to payment of the account as a receivable in respect of which third-party effectiveness of a security right can be achieved only through registration in the general security rights registry, or permitting third-party effectiveness to be achieved by means of a control agreement without the need for registration), a transferee of funds from a bank account under a transfer initiated by the grantor in the ordinary course of business takes free of the security right (see A/CN.9/631, recommendation 103). Otherwise, the two approaches have quite different priority consequences. Under the first approach, priority as a general rule turns on the order of registration of the security rights. The depositary bank does not enjoy any special priority status in its capacity as a secured creditor (although it typically has a right under other law to set off any claims it has against the grantor against a demand for payment by a prior ranking secured creditor and this normally means that it has a de facto priority). Under the

second approach, a depositary bank with automatic control has priority over other secured creditors, except one that achieves control by replacing the grantor as the bank's customer on the account (see A/CN.9/631, recommendation 101).

117. The first approach ensures transparency through public registration and permits the grantor to create a security right without the consent of the depositary bank. The second approach is more in line with banking practice. Automatic control in favour of the depositary bank is analogous to the law of set-off, which permits a depositary bank to apply funds credited to its customer's account and therefore owing to the grantor against any amounts the customer owes the bank as a result of an extension of credit to the customer. However, the bank's right of set-off for future loans is usually defeated once it receives notice of the creation of a security right (or assignment) in favour of a third party. This may create difficulties for depositary banks and their commercial customers that often must be in position to act very quickly in bank account-related financing transactions. The need to ensure that no notice of a third-party assignment or security right has been received before acting on the customer's instructions may interfere with the efficiency of these transactions. Uncertainties about the precise timing of the receipt of notice and the bank's extension of credit may also invite litigation between a third-party secured creditor or assignee and the bank. The concept of automatic control, combined with the priority awarded to the depositary bank, eliminates this source of risk and uncertainty.

118. The approach that permits third-party effectiveness to be achieved through "control" with respect to the account does not have any adverse effects on the grantor. In the first place, the grantor must consent to the creation of a security right in favour of the depositary bank. Presumably the grantor will withhold this consent if the bank is not a source of financing. In addition, the priority rules associated with control can be altered by a subordination agreement in those situations where it would be more appropriate to ensure that first priority is given to another secured creditor. In a competitive banking environment, banks will not unreasonably withhold their consent to subordination (or to the conclusion of a control agreement), since the grantor is always free to change its account to another institution.

119. As for the lack of transparency inherent in the concept of control, it does not put third parties in a more disadvantageous position than they already occupy. As noted above, a depositary bank generally has the right under other law to set-off any obligations owing to it by the grantor in preference to rights of the grantor's creditors, both secured and unsecured. Since set-off is not a security right, it is not subject to any public registration requirement. Nor is the bank obligated to disclose its rights of set-off to third parties. Thus, creditors in States that adopt the first approach cannot rely on a clean search of the registry since the bank may always assert a preference under its private right of set-off. Nor are transferees of funds paid out of the account on the instructions of the grantor prejudiced since, as noted above, they generally take free of the security under both approaches.

120. States that have adopted the concept of "control" as a method for achieving third-party effectiveness do not make it an exclusive method. In other words, in these States third-party effectiveness may be achieved either by registration or by control. As noted, however, there are strong incentives for a secured creditor to achieve third-party effectiveness by control. A secured creditor with control has

priority over any secured creditor that merely registers, regardless of the respective order of occurrence of control and registration (see A/CN.9/631, recommendation 101). Registration does, however, ensure that the security right will be effective against the grantor's judgement creditors and insolvency administrator since the priority given to the secured creditor with control may be claimed only against other secured creditors, and not as against all competing claimants (see A/CN.9/631, recommendation 101). Because the second approach is more in conformity with banking practices and the usual expectations of banks and their commercial customers, this Guide recommends that in addition to registration in the general security rights register, "control" be accepted as a privileged method for achieving third-party effectiveness over the right to payment of funds credited to a bank account (see A/CN.9/631, recommendation 50).

3. Third-party effectiveness of a security right in proceeds under an independent undertaking

121. As explained in chapter IV (see A/CN.9/631/Add.1, paras. …), in many States, a security right may be created in proceeds under an independent undertaking (for the definition of the term, see A/CN.9/631/Add.1, para. 19), but not in the right to draw under an independent undertaking (see A/CN.9/631, recommendation 28). On the other hand, some States do not permit a security right to be taken even in the proceeds of an independent undertaking. However, even among States that take the position recommended in this Guide, the particular character of the specific asset leads States to adopt different policies as to methods for achieving third-party effectiveness.

122. In some States, such a security right may be made effective against third parties in more than one way. For example, while it is impossible for the secured creditor to take possession since the asset (the proceeds under an independent undertaking) cannot exist in corporeal form unless and until paid, the secured creditor may register a notice in the general security rights registry. Alternatively, in States that recognize the idea of "control" (for the definition of "control" with respect to a security right in proceeds under an independent undertaking, see A/CN.9/631/Add.1, para. 19) the secured creditor may automatically have control or enter into a control agreement depending on the circumstances.

123. In other States, "control" is the exclusive method recognized for achieving third-party effectiveness of a security right in a right to proceeds under an independent undertaking. Control and, therefore third-party effectiveness, exists automatically if the secured creditor is the issuer or other nominated person (for the definitions of these terms, see A/CN.9/631/Add.1, para. 19). If the secured creditor is a third party, control requires the issuer or other nominated person to acknowledge the secured creditor's entitlement to receive the proceeds upon a proper draw by the beneficiary. Under this approach a secured creditor can obtain control and, therefore, third-party effectiveness only if the issuer consents to pay any properly drawn proceeds to the secured creditor. The consent of the issuer is necessary because the issuer needs to be assured that the presentation has been duly made and that the beneficiary has agreed to the secured creditor's right to receive the proceeds. Otherwise, it might find itself liable to the beneficiary for breaching the terms and conditions of the undertaking by paying the proceeds to a secured creditor that does not have the right to receive the payment.

124. As noted, the very nature the right to proceeds under an independent undertaking makes it impractical to achieve third-party effectiveness by taking possession of the proceeds. However, a secured creditor might take possession of the instrument itself. While possession of the independent undertaking does not achieve third-party effectiveness, possession would give a practical level of protection to a secured creditor when the terms of the independent undertaking require the physical presentation of the independent undertaking to the issuer in order to make a draw. As the beneficiary could not make an effective draw without the secured creditor's cooperation, a secured creditor in possession could protect itself by requiring the beneficiary to obtain an acknowledgement that would achieve control before surrendering possession of the instrument.

125. The particular practices of the letter of credit and independent guarantee industry have an important bearing on the manner in which a security right may be created in rights arising from an independent undertaking and the very rights upon which security might be taken (see A/CN.9/631, recommendation 28). These same particular practices require special attention to the methods by which third-party effectiveness, and especially effectiveness as against the issuer and nominated person, may be achieved. In order to protect the issuer against potential liability for payment to a secured creditor when presentation may not have been duly made, or when conditions in the security agreement may disentitle the secured creditor from claiming payment once a draw has been properly made, this Guide recommends that control be the exclusive method by which a secured creditor may achieve third-party effectiveness (see A/CN.9/631, recommendation 51).

4. Third-party effectiveness of a security right in a negotiable document or the goods covered by a negotiable document

126. The central characteristic of a negotiable document (e.g. a bill of lading) is that it represents the goods that are covered by it (for the definition of "negotiable document", see A/CN.9/631/Add.1, para. 19). Because the document is negotiable it has the quality of tangibility that permits its holder to claim possession of the rights it represents. Delivery of a properly endorsed negotiable document is also generally treated as effective to transfer rights to the goods represented by the document. For this reason, in most States, a security right in a negotiable document will normally also extend to the goods covered by the negotiable document. If the security right in the negotiable document is effective, the security right in the goods covered by the document is also effective (see A/CN.9/631, recommendation 53).

127. The tangible character of the negotiable document means that, where States have a general security rights registry, a security right in the document may be made effective against third parties either (i) by registration in the general security rights registry or (ii) by transfer of possession of the document to the secured creditor as long as the goods are covered by the document (see A/CN.9/631, recommendation 52).

128. While registration and possession are alternative means of achieving third-party effectiveness, they do not produce identical consequences. In most States, a secured creditor that takes possession of the document during the period that the goods are covered by it has priority over competing claimants such as buyers or other transferees, and secured creditors, including secured creditors that may have achieved third-party effectiveness through an earlier in time registration in the

general security rights registry. This approach reflects and supports the need to preserve the negotiable character of the document in commercial practice and for this reason it is the approach recommended in this Guide (see A/CN.9/631, recommendation 107).

129. In practice, a secured creditor may have to relinquish possession of the document to enable the grantor to deal with the goods in the course of its business. Normally, this would result in the lapse of third-party effectiveness, unless the secured creditor had also achieved third-party effectiveness through registration. In many States, however, the creditor that has not registered a notice of its security right may nonetheless benefit from a temporary period of automatic third-party effectiveness (e.g. fifteen or twenty days) following relinquishment of possession of the document to enable the grantor to sell, exchange, load or unload or otherwise deal with the goods covered by the negotiable document. This automatic third-party effectiveness is not conditional on the secured creditor once again achieving third-party effectiveness before the expiry of the period. This means that the security right is effective against third-party rights that arise during the temporary period even if the security right is not otherwise made effective against third parties before the expiry of the short period. This approach reflects the typically short-term nature of financing transactions based on goods represented by a negotiable document which usually involve financing under an international sale of goods between a manufacturer or primary producer in one State and a wholesale buyer in another State. In the usual course of events, the secured creditor in this type of transaction will have been paid before the expiry of the period and will never retake possession of the negotiable document (see A/CN.9/631, recommendation 54).

130. It is, however, important to note that in order for this automatic third-party effectiveness to exist, the security agreement must have been concluded (that is, the security right must be effective as between the parties). Consider the case where a security right has been created by oral agreement and a transfer of possession to the secured creditor. The transfer of possession is not simply a method for achieving third-party effectiveness. It is an essential element for the creation of a security right by oral agreement. However, where a security right is not created by a transfer of possession writing is necessary. Hence, should the secured creditor later relinquish possession temporarily, automatic third-party effectiveness will not result unless there is a writing sufficient to ensure that the security right continue to exist as between the parties.

[*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.*]

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*.]