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Draft legislative guide on secured transactions

Note by the Secretariat*

Addendum

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A. General remarks

1. Introduction

1. A security agreement sets out the bargain between the grantor and the secured creditor. Its substantive content will vary according to the needs and wishes of the parties. Typically, clauses in security agreements address three main themes. First, some provisions are included because they form part of the mandatory requirements for creating a security right. Rules relating to the identification of the encumbered asset and the secured obligation are of this type (for the definitions of "encumbered asset" and "secured obligation", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). In chapter IV (Creation of a security right (effectiveness as between the parties)), this Guide recommends that the formal requirements for creating a security agreement that is effective as between the parties should be minimal and easy to satisfy (see A/CN.9/631, recommendations 12-14).

2. The typical security agreement will also contain several terms specifying the rights and obligations of the parties once the agreement has become effective between them. Many of these terms deal with the consequences of a default by the grantor or the breach of an obligation by the secured creditor. Often the events constituting a default by the grantor and the remedies available to the secured creditor to enforce the terms of the security agreement are enumerated in detail. The significant impact that enforcement may have on the rights of third parties usually has led States to specify in some detail a series of mandatory rules governing default and enforcement (see chapter X, Post-default rights). Nonetheless, unless the terms of the security agreement relating to a creditor's contractual rights and remedies conflict with mandatory rules or are waived by the grantor after default (see A/CN.9/631, recommendation 130) or by the secured creditor at any time (see A/CN.9/631, recommendation 131) they will govern the relationship between the parties once a default occurs.

3. In addition, security agreements usually contain a series of other provisions meant to regulate the relationship between the parties after creation but prior to default. That is, efficiency and predictability in secured transactions often call for additional detailed clauses aimed at covering particular aspects of the ongoing transaction. Many States actively encourage the parties themselves to fashion the terms of the security agreement to meet their own requirements. Nonetheless, these same States are also anxious to frame certain mandatory rules to govern pre-default rights and obligations (especially when third-party rights may be in play). However, in order to enhance the flexibility offered to grantors and secured creditors to tailor-make their agreement, States usually keep these mandatory pre-default rules to a minimum.

4. While States are generally reluctant to specify a full menu of mandatory rules governing the pre-default relationship between the parties, this does not mean that they have no interest in providing guidance to grantors and secured creditors. Indeed, many States enact a greater or lesser number of other, non-mandatory (or suppletive) rules detailing the parties' rights and obligations before default,

should they not specify these terms in the security agreement. This chapter does not address all the situations where States may wish to develop non-mandatory rules. Rather, it offers only an indicative and non-exhaustive list of those non-mandatory rules concerning pre-default rights and obligations which are commonly found in contemporary national legislation.

5. The discussion that follows focuses on three policy issues. The first, examined in section A.2, relates to the principle of party autonomy and the extent to which parties should be free to fashion the terms of their security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second, explored in section A.3, relates to the mandatory rules that should govern pre-default rights and obligations of grantors and secured creditors. The third, which is the subject of sections A.4 and A.5, concerns the type and number of non-mandatory rules that could be included in modern secured transactions legislation, so as to encompass new and evolving forms of secured transactions.

6. Section B of this chapter considers the various mandatory and non-mandatory rules that might be contemplated to deal with pre-default rights and obligations in relation to particular types of asset and transaction. The chapter concludes, in section C, with a series of recommendations.

2. Party autonomy

7. In chapter II (Scope of application and other general rules), this Guide announces the principle of party autonomy as one of the foundations of its basic approach (see A/CN.9/631, recommendation 8). The central idea is that, unless a State provides otherwise, the secured creditor and the grantor should be free to craft their security agreement as they see fit. While party autonomy gives credit providers significant power in determining the content of the security agreement, the expectation is that permitting the secured creditor and the grantor to structure their transaction and allocate pre-default rights and obligations as best suited to their objectives will normally permit grantors to gain wider access to secured credit.

8. The party autonomy principle has two distinct dimensions when applied to pre-default rights and obligations. The first is aimed at States. While States should be free to enact mandatory rules to govern the ongoing relationship between parties, their number should be limited and their scope clearly stated. The second is directed to the grantor and the secured creditor. Any agreement that derogates from or modifies non-mandatory rules only binds the parties to that agreement and does not affect the rights of third parties.

9. Legislative limitations on party autonomy in the form of mandatory rules can be found both within a secured transactions law and in other laws. So, for example, many States extensively regulate consumer transactions, often strictly limiting the capacity of secured creditors and grantors to design their own regime of pre-default rights and obligations. An example would be a rule that prohibits secured creditors from limiting the right of consumer grantors to sell or dispose of the encumbered assets. Likewise, many States impose limitations where property described as “family property” or “community property” is at issue. An example would be a rule that prevents secured creditors from limiting the use to which grantors may put such “family property”.

10. In addition to these mandatory rules that govern particular grantors and particular property, it is common for States to impose various mandatory rules of a more general character. These are usually found within the legislation that creates the secured transactions regime and, as noted, they most often relate to default and enforcement. But some also concern pre-default rights and obligations. These latter types of mandatory rules are discussed in the next section of this chapter.

11. Because party autonomy is the basic principle, the secured creditor and the grantor will typically set out in detail a number of structural elements of their agreement. At least six pre-default dimensions of the agreement are typically specified by the grantor and the secured creditor:

(a) They will agree on the assets to be encumbered and the conditions under which assets not initially encumbered may later become encumbered;

(b) They will define the obligation to be secured as well as provide for any future obligations that may be secured under the agreement;

(c) They will attempt to specify what the grantor can and cannot do with the encumbered assets (including the right to use, transform, collect fruits from and dispose of the property);

(d) They will specify if, when and how the creditor may obtain possession of the encumbered assets prior to default, and the rights of the creditor with respect to those encumbered assets in its possession;

(e) They will specify a series of representations, warranties and obligations that the grantor undertakes; and

(f) They will define the events triggering default (primarily of the grantor, but also of the secured creditor) under the agreement.

12. It is against this background of party autonomy and its usual scope as set out in the security agreement that the various mandatory and non-mandatory rules should be read.

3. Mandatory pre-default rules

(a) General

13. Mandatory rules relating to pre-default rights and obligations of the parties may be found both in secured transactions law and in other laws. Generally these rules are of three broad types. Some rules, which States usually enact in consumer protection or family property legislation, have a very particular scope and application. This Guide recognizes the importance that States may attach to these matters (see chapter II, Scope of application and other general rules). In order to achieve the maximum economic benefit from a secured transactions regime however, States should clearly specify the scope of these limitations on the parties' freedom to tailor pre-default rights and obligations to their needs and wishes.

14. Other pre-default mandatory rules focus on the substantive content that parties may include in their agreement. Usually these rules are conceived as general limitations on the rights of secured creditors. They can vary widely from State to State. For example, some States attempt to prevent creditor overreaching and over-collateralization by enacting rules that require creditors to grant a release over

property that is no longer necessary to secure the outstanding balance of the obligation due. Similarly, some States do not permit creditors to restrict the right of a grantor to use or transform the encumbered assets as long as this use or transformation is consistent with the nature and purpose of those assets.

15. Because of the importance that this Guide attaches to the principle of party autonomy it takes the position that States generally ought not to enact pre-default mandatory rules that restrict the number or nature of the obligations that secured creditors and grantors may require of each other. Still, the above concerns are often real and depending on the particular character of their national economy States may feel the need to more closely regulate certain aspects of the pre-default relationship between secured parties and grantors. Should they do so, however, it follows from the principle of party autonomy that such mandatory rules should (a) be expressed in clear and limited language; and (b) like similar rules in the post-default context, be based on recognized grounds of public policy (*ordre public*) such as good faith, fair dealing and commercial reasonableness (see A/CN.9/631, recommendations 128 and 129).

16. A third type of mandatory rule aims at ensuring that the fundamental purposes of a secured transactions regime are not distorted. Typically, States deploy rules of this type to impose minimum duties upon the party that has possession or control of the encumbered assets. So, for example, as the point of security is to provide a creditor with a priority right to claim, upon default, payment through the value of the encumbered asset, it would be consistent with the logic of the institution that grantors assume an obligation not to waste or otherwise allow the encumbered assets to deteriorate beyond what would be expected from normal usage.

17. Rules requiring the grantor and, in the case where the secured creditor has possession, the secured creditor to take reasonable care of the encumbered assets, and more generally rules directed to preserving the value of the encumbered assets, are meant to encourage responsible behaviour by parties to a security agreement. These types of mandatory rules are not, however, identical in impact to consumer-protection rules or mandatory rules stipulating the substantive content of a security agreement. The latter types of mandatory rule are constitutive of the security right itself and cannot be waived either at the time the agreement is negotiated or afterwards.

18. Mandatory rules setting out pre-default rights and obligations (or any mandatory rules) may not be derogated from in the security agreement. For example, parties may not contract out of their duty to take reasonable care of the encumbered assets. However, this does not always disable parties from waiving a breach of the duty after the fact. Many States provide that the secured creditor may later release the grantor from its pre-default obligations or may waive any breaches by the grantor (even of obligations imposed by mandatory rules). By contrast, given the usual dynamic between secured creditor and grantor, many of these same States also provide that the grantor cannot release the secured creditor from any duties imposed by mandatory rules.

19. The mandatory pre-default rules recommended in this Guide aim at policy objectives consistent with what have been defined as the core principles of an effective and efficient regime of secured transactions. They set out pre-default rights and obligations that (a) encourage parties in possession to preserve the pre-default

value of the encumbered assets; and (b) ensure that once the obligation is paid, the grantor recovers the full use and enjoyment of the previously encumbered assets.

20. Chapter XII (Acquisition financing rights) of this Guide contemplates that some States might choose to preserve retention-of-title and financial lease transactions as independent forms of acquisition financing rights. In these situations, the seller's right is not a security right but rather constitutes ownership of the property sold until full payment of the purchase price (for the definitions of the terms "security right", "acquisition financing right", "retention of title" and "financial lease", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). For this reason, even though the fundamental economic objectives of the transaction are identical to those of an ordinary security right, the mandatory rules concerning pre-default rights and obligations of the parties (the seller that retains ownership and the buyer that has possession but only an expectancy of ownership) will have to be framed in slightly different language. These necessary adjustments are discussed in chapter XII, section A.8.

(b) Duty to preserve the encumbered assets

21. The encumbered asset is one of the creditor's principal assurances of repayment of the secured obligation. It is also an asset that the grantor normally expects and intends to continue using freely once the loan or credit has been repaid. For these reasons both secured creditors and grantors have an interest in maintaining the value of the encumbered asset.

22. Most often the person that has possession of an encumbered asset will be in the best position to ensure its preservation. This explains why States normally impose the duty to take reasonable care of the encumbered asset on that party. Only by exception, and almost invariably in relation to intangible property, might a person not in notional possession be optimally positioned to care for the encumbered asset. In view of the objective of ensuring a fair allocation of responsibility for caring for encumbered assets and encouraging parties to preserve their value, it matters little whether it is the grantor or the secured creditor that has possession. The mandatory duties imposed on the person in possession should be identical in both cases.

23. The specific content of the duty may vary considerably, depending on the nature of the encumbered asset. In the case of tangible property, the duty points first to the physical preservation of the asset (for the definitions of "tangible property" and "intangible property", see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation). Where inanimate tangible property is concerned, this usually would include a duty to keep property in a good state of repair and not to use it for a purpose other than that which is normal in the circumstances. For example, if a piece of machinery is at issue, it must not be left out in the rain and the party that possesses and uses it must perform routine maintenance. If security is taken on a passenger automobile, the person in possession cannot use the vehicle as a light truck for commercial purposes.

24. In the case of living tangible property such as animals, the duty should be similar. It is not enough simply to keep the animal alive. The person in possession must ensure that the animal is properly fed and is maintained in good health (for example, receives adequate veterinary care). Where the animal requires special

services to maintain its value (for example, proper exercise for a race horse, regular milking for a cow), the duty of care extends to providing these services. Finally, as with equipment, the duty also means that the animal cannot be used for abnormal purposes. Thus, a prize bull the value of which lies in stud fees cannot be used as a beast of burden.

25. If the encumbered asset consists of tangible property, such as a right to payment of money embodied in a negotiable instrument, the duty will certainly include the physical preservation of the document. In such a case, however, the duty of care will include taking the necessary steps to maintain or preserve the grantor's rights against prior parties bound under the negotiable instrument (for example, the presentation of the instrument, protesting it if required by law, as well as providing notice of dishonour). It may also be incumbent upon the person in possession of a negotiable instrument to preserve its value by taking steps against persons secondarily liable under the instrument (e.g. guarantors). Where the tangible property is a negotiable document, here also the person in possession must physically preserve the document. Moreover, should the document be time limited, the person in possession of the document must present it prior to expiry to claim physical possession of the property covered by the document.

26. If the encumbered asset consists of intangible property, it is more difficult to fix the duty to take reasonable care by reference to the person in possession. Frequently, the intangible property is a simple contractual right to receive payment. The character of the duty of preservation in such cases is discussed below in section B. Where the encumbered asset is a right to payment of funds credited to a bank account, intellectual property or proceeds under an independent undertaking, States typically provide for the respective rights and obligations of parties to the transaction in special legislation regulating that particular form of property.

27. Consistent with the above considerations, this Guide recommends that States enact a general mandatory pre-default rule aimed at ensuring a fair allocation of responsibility for caring for encumbered assets and encouraging parties in possession to preserve the pre-default value of the encumbered assets (see A/CN.9/631, recommendation 109, subpara. (a)).

(c) Duty to return the encumbered asset and to terminate the notice

28. The central purpose of a security right is to enhance the likelihood that the grantor will repay any obligation owed to the secured creditor. A security right is not a means of expropriating surplus value from the grantor or a disguised transfer of that property to the creditor. For this reason, most States enact mandatory rules to regulate the duties of the secured creditor once the secured obligation has been repaid in full and all credit commitments have been terminated. These duties are of two types. Some duties relate to the return of the encumbered assets to the grantor, should the secured creditor be in possession of the assets during the duration of the agreement; other duties relate to ensuring that the grantor's rights to the encumbered assets are free from any residual encumbrance.

29. This Guide contemplates that secured creditors may make their rights effective against third parties by taking possession of the secured property (see A/CN.9/631, recommendation 35). In addition, even when creditor possession is not taken to achieve third-party effectiveness, given the principle of party autonomy, grantors

may agree to permit secured creditors to take possession of their assets at the time of creating the security right, or at some time thereafter, even if they are not in default. In either event, however, the secured creditor's possession is grounded in the agreement between the parties and relates to the specific objectives of that agreement. For this reason, most States enact mandatory rules governing the duties of a secured creditor that has possession or control of encumbered assets once the secured obligation has been repaid, or any commitments to extend further credit have been terminated.

30. Since the purpose of a security right is to ensure the performance of an obligation, once that performance has occurred, the grantor should be able to recover either possession of the encumbered assets or unimpeded access to them, or both. This explains the formal duty that many States impose on secured creditors to return the encumbered assets to the grantor upon full payment of the secured obligation (and termination of all credit commitments). The burden lies on the creditor to deliver the encumbered assets, and not on the grantor to reclaim them or to take them away. Likewise, where the secured creditor and a deposit-taking institution have entered into a control agreement, many States require the secured creditor specifically to inform the depositary that the control agreement is no longer in effect. Both of these requirements are intended to ensure that the grantor automatically acquires the free use of encumbered assets once the secured obligation has been paid in full and all credit commitments have been terminated.

31. Some States consider that the creditor must also take positive steps to ensure that the grantor is placed in the same position that it occupied prior to the creation of the security right. In the case of intangible property, this would require sending a notice to any third-party obligor (for example, the debtor of a receivable) indicating that the secured obligation has been paid in full and that the grantor is again entitled to receive payment of the receivable (for the definitions of "receivable" and "debtor of the receivable", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). More generally, some States oblige secured creditors to release the encumbered assets from the security right and to ensure that evidence of that security right be expunged from the record of the relevant registry. So, for example, where registrations are not automatically purged from a registry, after a relatively short period of time creditors are often required to request the registry to cancel the registration. Similarly, where the security right has been made the subject of a notice on a title certificate, some States require the secured creditor to ensure the deletion of the notice on the title certificate. The unifying theme of these requirements is that the secured creditor should take whatever steps are necessary to ensure that no third party might think that the grantor's assets are still potentially subject to its security right.

32. The mandatory rule recommended in this Guide to govern the relationship of the parties once the secured obligation has been paid broadly reflects these considerations. Its primary objective is to make certain that the grantor recovers the full use and enjoyment of the previously encumbered property and is able to deal effectively with it in transactions involving third parties (see A/CN.9/631, recommendation 109, subpara. (b)).

4. Non-mandatory pre-default rules

33. In addition to various mandatory rules governing pre-default rights and obligations of the parties, most States develop a longer or shorter list of non-mandatory rules addressing the same issues. The vocabulary used to identify rules "subject to contrary agreement between the parties" varies from State to State (e.g. *jus dispositivum, lois supplétives, normas supletorias*, non-mandatory rules, default rules). Their common feature, however, is this: they are meant to apply automatically, unless there is evidence that the parties intended to exclude or amend them.

34. Different policy rationales are offered to support the idea of non-mandatory rules. Some States use non-mandatory rules to protect weaker parties. Other States conceive them as rules simply mirroring the terms of an agreement that parties would have negotiated had they turned their attention to particular points. This Guide takes the position that the true justification for non-mandatory rules lies in the fact that they can be used to promote policy objectives consistent with the logic of a regime of secured transactions. Examples of non-mandatory rules grounded in this rationale are not hard to find. The law in many States provides that, unless the parties agree otherwise, the grantor will deposit any insurance proceeds obtained because of the loss of the encumbered asset in a deposit account controlled by the secured creditor; or again, the law in many States provides that, unless the parties agree otherwise, revenues deriving from the encumbered asset may be retained by the secured creditor during the life of the security agreement, so that in case of default those revenues may be applied to the payment of the secured obligation. In view of this general objective, there are at least four reasons why States might choose to develop a panoply of non-mandatory rules.

35. First, by allocating rights and obligations between a secured creditor and a grantor in the manner to which they themselves would most likely agree, given the basic purposes of a secured transactions regime, a set of non-mandatory rules helps to reduce transaction costs, eliminating the need for the parties to negotiate and draft new provisions already adequately covered by these rules. Here non-mandatory rules serve as implied or default (i.e. applicable in the absence of agreement to the contrary) terms that, unless a contrary intention is expressed in the security agreement, are deemed to form part of that agreement. An example of such an implied term would be a rule that permits a secured creditor in possession of the encumbered asset to retain any revenues produced by that asset and to apply them directly to the payment of the secured obligation.

36. Second, even the best-advised and most experienced parties do not possess infallible insight into the future. However carefully drawn the agreement, there will be unforeseen circumstances. To obviate the need for a judicial or arbitral decision to fill these gaps when they arise and to reduce the number of potential disputes, States usually provide for basic characterization rules. These non-mandatory rules direct parties to other, more general, legal principles that can be deployed to guide the resolution of unanticipated problems. An example of such a rule is that which provides that the grantor of a security right remains the holder of the substantive right (be it ownership, a lesser property right or a personal right) over which security has been taken. Thus, in working through any particular unforeseen event, the parties may begin with the principle that the exercise of any right not specifically allocated to the secured creditor remains vested in the grantor.

37. Third, a relatively comprehensive legislative elaboration of the rights and obligations of the parties before default increases efficiency and predictability by directing the attention of parties to issues that they should consider when negotiating their agreement. A series of default rules from which they may opt out can serve as a drafting aid, offering a checklist of points that might be addressed at the time the security agreement is finalized. Even when parties decide to modify the stated non-mandatory rules so as to better achieve their purposes, the exercise of having attended to them ensures that these matters are considered and not inadvertently left aside.

38. Finally, non-mandatory rules make it possible for the principle of party autonomy to operate most efficiently. This benefit is particularly evident in long-term transactions or other speculative transactions where the parties cannot anticipate every contingency. Such rules facilitate flexibility and reduce compliance costs. For example, treating the agreement as complete in itself and requiring the parties to formalize all subsequent modifications and amendments to that agreement simply imposes additional transaction costs on the grantor.

39. The advantages of permitting the parties to define their relationship with the assistance of a set of non-mandatory rules are widely recognized by many national legal systems (e.g. arts. 2736-2742 of the Civil Code of Québec, Canada, and arts. 9-207 to 9-210 of the Uniform Commercial Code in the United States), by organizations that promote regional model laws (e.g. art. 15 of the European Bank for Reconstruction and Development Model Law on Secured Transactions and art. 33 of the Organization of American States Model Inter-American Law on Secured Transactions), and by international conventions dealing with international sales (i.e. art. 6 of the United Nations Convention on Contracts for the International Sale of Goods)[1] or some aspect of secured transactions in movable assets (e.g. art. 11, para. 1, of the United Nations Convention on the Assignment of Receivables in International Trade[2] (hereinafter the "United Nations Assignment Convention") and art. 15 of the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment).

5. Typical non-mandatory pre-default rules

(a) General

40. This chapter does not address all of the situations where States may wish to develop non-mandatory rules. For example, it does not deal with non-mandatory rules that may be developed in relation to the basic terms required for a security right to exist (e.g. the minimum contents of the security agreement). Non-mandatory rules in this context fulfil a different function and their desirability, scope and content would, therefore, be governed by different policy considerations. Moreover, and for the same reason, it does not consider non-mandatory rules that are meant to govern post-default rights and obligations of the parties. These non-mandatory rules are addressed in chapter X (Post-default rights).

41. The non-mandatory rules discussed in this section are those directed to pre-default rights and obligations of the parties. Yet, because non-mandatory rules

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[1] United Nations publication, Sales No. E.95.V.12.

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

will usually reflect the needs, practices and policies of particular States their specific configuration varies enormously. Still, there is a core of non-mandatory rules that are commonly found in contemporary national legislation. They serve as a complement to mandatory rules dealing with the rights and duties of persons in possession of encumbered assets.

42. Like mandatory rules, these non-mandatory rules are meant to encourage responsible behaviour on the part of those having control and custody of encumbered assets. Hence, States organize them according to whether the secured creditor or the grantor has possession of the encumbered assets. Some non-mandatory rules, however, are intended to apply regardless of whether the security is possessory or non-possessory. These three situations are considered in turn.

(b) Creditor-in-possession security rights

43. As already noted, most States have mandatory rules that require secured creditors in possession to take reasonable care of, to preserve and to maintain the encumbered assets in their possession. Typically, the secured creditor is also bound to undertake all necessary repairs to keep the encumbered asset in good condition. The basic content of these mandatory rules has already been discussed. In addition, some States enact a series of non-mandatory rules that specify further obligations of creditors to care for encumbered assets in their possession, especially in cases where the encumbered asset generates civil and natural fruits, or is otherwise an income-producing asset. The following paragraphs address the more common non-mandatory rules of this type.

44. As for the basic obligation of care and preservation, many States specifically require, in the case of tangible property, that the secured creditor must keep the encumbered asset clearly identifiable. If it is fungible and commingled with other assets of the same nature, this duty is transformed into an obligation to keep assets of the same quantity, quality and value as that originally encumbered. In addition, where maintenance requires action beyond the creditor's capacity, States often require the creditor to notify the grantor and, if necessary, to permit the grantor temporarily to take possession to repair, care for or preserve the asset or its value.

45. Where the encumbered asset consists of an instrument embodying the grantor's right to the payment of money, the obligation of care on the part of the secured creditor is not limited to the physical preservation of that document. Many States require the secured creditor to take necessary steps to maintain or preserve the grantor's rights against prior parties bound under the negotiable instrument or secondarily liable, and also permit either the grantor or the secured creditor to sue for enforcement of the payment obligation.

46. Another non-mandatory rule (a corollary of the duty of the secured creditor in possession to take care of the encumbered asset) is that the secured creditor is entitled to obtain reimbursement for reasonable expenses required to preserve the asset and to have these expenses included within the secured obligation. In addition, many States permit the secured creditor to make reasonable use of or operate the encumbered asset (see A/CN.9/631, recommendation 108). As a concomitant of this right, the secured creditor must allow the grantor to inspect the encumbered asset at

all reasonable times and will be liable in damages for any deterioration of the asset beyond that associated with normal use.

47. Because the secured creditor is in possession, it will most often be in the best position to collect monetary proceeds (revenues or civil fruits) or non-monetary proceeds (natural fruits included in the definition of proceeds, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) derived from the encumbered asset. For this reason, it is common for States to enact a non-mandatory rule that both monetary and non-monetary proceeds are to be collected by the secured creditor in possession. Normally, it is the grantor that will be able to get the best price for the natural fruits generated by secured property (for example, milk produced by a herd of cows, eggs produced by chickens, wool produced by sheep). Therefore, States usually also provide that the secured creditor should turn the fruits over to the grantor for disposition. Alternatively, where the fruits involve the natural increase of animals, for example, a common non-mandatory rule is that such offspring are automatically encumbered and held by the creditor under the same terms.

48. Where the proceeds are monetary it makes little sense to oblige the creditor, after collection, to turn these over to the grantor. The usual non-mandatory rule is that the secured creditor may either apply cash proceeds to repayment of the secured obligation, or hold them in a separate account as additional security. This principle operates whether the money received is interest, a blended payment of interest and capital, or a stock dividend. Some States even permit the creditor to sell additional stock received as a dividend or to hold it (in the manner of the offspring of animals) as additional encumbered assets.

49. As for the right of disposition, there is great diversity in the manner States enact non-mandatory rules. In any case, the creditor cannot waste the encumbered asset. However, some States provide that the secured creditor may assign the secured obligation and the security right. That is, the creditor may transfer possession of the encumbered asset to the person to whom it has assigned the secured obligation. Some States also provide that the secured creditor may create a security right in the encumbered asset as security for its own debt ("re-pledge the encumbered property") as long as the grantor's right to obtain the assets upon payment of the secured obligation is not impaired. Often these re-pledge agreements are limited to stocks, bonds and other instruments held in a securities account, but in some States creditors may re-pledge tangible property such as diamonds, precious metals and works of art. By contrast, many States prohibit the secured creditor in possession from re-pledging the encumbered assets, even if it can do so on terms that do not impair the grantor's right to recover its property upon performance of the secured obligation.

50. The risk of loss or deterioration of property normally follows ownership, not possession. Nonetheless, many States provide that where encumbered assets in the possession of the secured creditor are destroyed or suffer abnormal deterioration, the secured creditor is presumed to be at fault and must make good the loss. Typically, however, the same non-mandatory rule provides that the creditor is not liable for loss if it can show that the loss or deterioration occurred without its fault. Because it will always be in the secured creditor's interest to ensure that the value of the encumbered assets is maintained, many States provide that the creditor has an insurable interest. Should the secured creditor then insure against loss or damage,

however caused, it is entitled to add the cost of the insurance to the obligation secured.

51. This last rule is a particular example of a broader principle enacted as a non-mandatory rule in many States and recommended by this Guide. Reasonable expenses incurred by the secured creditor while discharging its custodial obligation to take reasonable care of the encumbered property are chargeable to the grantor and automatically added to the obligation secured (see A/CN.9/631, recommendation 108, subpara. (a)). Tax payments, repairer's bills and storage charges are examples of such reasonable expenses for which the grantor is ultimately liable.

(c) Grantor-in-possession security rights

52. A key policy objective of an effective secured transactions regime is to encourage responsible behaviour by the grantor that remains in possession of the encumbered assets. Maintaining the pre-default value of the encumbered assets is consistent with this objective. However, the policies underlying the non-mandatory rules for grantor-in-possession security are also aimed at maximizing the economic potential of the encumbered assets. In particular, encouraging the use and exploitation of encumbered assets is a way to facilitate revenue generation, and repayment of the secured obligation, by the grantor.

53. For this reason, most States provide that the grantor in possession does not surrender the general prerogatives of ownership simply because a security right has been created. Unless the parties otherwise agree, the grantor is entitled to use, mix, process and commingle the encumbered assets with other property in a manner that is reasonable and consistent with its nature and purpose and the purposes of the security agreement. In such a case, the secured creditor should have the right to monitor the conditions in which the encumbered asset is kept, used and processed by the grantor in possession and to inspect the asset at all reasonable times (see A/CN.9/631, recommendation 108, subpara. (b)). The duty to take care resting on the grantor in possession includes keeping the encumbered asset properly insured and ensuring that taxes are paid promptly. If the secured creditor incurs these expenses, even though the grantor remains in possession, the secured creditor has the right to reimbursement from the grantor and may add these expenses to the secured obligation.

54. If the encumbered assets consist of income-producing property in possession of the grantor, to the extent that the creditor's security right extends to the income or revenues generated by the asset, the grantor's duties may include maintaining adequate records and the reasonable rendering of accounts regarding the disposition and the handling of the proceeds derived from the encumbered assets. Specific obligations of the grantor in the case of intangible property (e.g. bank accounts, royalties from the use of patents, copyrights and trademarks), and particularly the grantor's right to payment in the form of receivables, are discussed in the next section.

55. Many States currently have a rule that protects fruits and revenues (as opposed to proceeds of disposition in the strict sense) from automatic re-encumbering under the security agreement. By contrast, this Guide provides that a security right extends to all proceeds generated by the encumbered asset. That is, unless otherwise agreed,

any increase in value or profit deriving from the encumbered assets in the grantor's possession is automatically subject to the security right, regardless of whether those additional assets are regarded as civil or natural fruits or as proceeds. To the extent that the fruits are in kind (e.g. increase in animals, stock dividends), the grantor may use and exploit them under the same terms and conditions as initially encumbered assets. Where they are agricultural products like milk, eggs and wool, most States provide that the grantor may sell them and that the secured creditor's rights may be claimed in the proceeds received. Where the civil fruits are revenues, the security right will extend to them as long as they remain identifiable. As a rule, however, the grantor will not only collect fruits and revenues, it will dispose of them in the ordinary course of business free of the security right.

56. The duty to preserve the encumbered asset normally means that the grantor in possession is responsible for loss or deterioration, whether caused by its fault or by fortuitous event. In principle, the grantor is not entitled to dispose of the encumbered assets without authorization of the secured creditor. If the grantor does so, the buyer will take the property subject to the security right. By way of exception, however, the grantor may dispose of the encumbered assets free of the security if they consist of inventory or consumer goods and they are sold in the seller's ordinary course of business (see A/CN.9/631, recommendation 87). Despite this limitation on disposition, because the grantor will normally retain the full use of the encumbered asset most States enact non-mandatory rules authorizing the grantor to create additional security rights charging already encumbered assets, the fruits and revenues they generate and the proceeds of their disposition.

(d) Possessory and non-possessory security rights

57. In addition to the rights specifically given to and obligations specifically imposed on secured creditors and grantors because of their possession of the encumbered assets, there are two common non-mandatory rules that speak to both secured creditor-in-possession (possessory) and grantor-in-possession (non-possessory) security. The first is a corollary of the idea that parties in possession should maintain the value of encumbered assets. If it should happen that the value of the encumbered assets were to decrease significantly for reasons that were unforeseeable at the time of the conclusion of the security agreement, and unrelated to any lack of attention by the party in possession, some States provide that the grantor will have to offer additional security to make up for the unexpected decrease in value. These States usually have other rules that restrict the capacity of secured creditors to over-collateralize (i.e. take a security right in assets of a significantly higher value than the value of the secured obligations). The assumption is that, in exchange for this limitation, the secured creditor should be able to require the grantor to offer further property in guarantee should the encumbered asset base fall precipitously. Moreover, this rule is often extended to normal deterioration of the value of the encumbered assets due to wear and tear or market conditions, whenever such deterioration reaches a significant percentage of the initial value of the encumbered assets.

58. A second common non-mandatory rule concerns the right of the secured creditor to assign both the obligation secured and the security right that attaches to it. Absent agreement to the contrary a secured creditor may freely assign the secured obligation and the accompanying security right (see, for example, art. 10 of the

United Nations Assignment Convention and A/CN.9/631, recommendation 26). Some States even provide that the secured creditor may do so even despite contractual limitations on assignment (see art. 9, para. 1, of the United Nations Assignment Convention and A/CN.9/631, recommendation 25). Where the secured creditor has possession, this implies that it may also transfer possession to the new secured creditor. In both cases, the assignee of the secured obligation cannot acquire greater rights as against the grantor or as against the encumbered asset than those that could be claimed by the assignor.

B. Asset-specific remarks

59. Most of the mandatory and non-mandatory rules pertaining to the pre-default rights and obligations of parties relate to the manner in which the prerogatives and responsibilities of ownership are allocated between the grantor and the secured creditor. These include, most importantly: (a) the obligation (invariably imposed upon the party in possession of the encumbered property to care for it, maintain it, and take steps necessary to preserve its value); (b) the right to use, transform, mix and manufacture encumbered property; (c) the right to collect fruits, revenues and proceeds generated by the property and to appropriate these to one's use; and (d) the right to pledge, re-pledge or dispose of encumbered assets, whether free of, or subject to, the security right.

60. These rules contemplate the cases where the encumbered asset is tangible property. Nonetheless, in chapter III (Basic approaches to security) this Guide notes the importance of intangible property and, in particular, rights to payment as property that a grantor might encumber. While certain categories of intangible property are excluded from this Guide (i.e. securities, see A/CN.9/631, recommendation 4), many other types of intangible property are included: notably, contractual and non-contractual receivables, rights to payment of funds credited to a bank account and proceeds under an independent undertaking (see A/CN.9/631, recommendation 2, subpara. (a)).

61. The creation of a security right in a right to payment necessarily involves parties other than the grantor and the secured creditor, most obviously the debtor of the receivable. For this reason States have developed detailed rules to regulate the rights and obligations of the parties and of third parties, whether the right arises under a tangible (e.g. a negotiable instrument or a negotiable document) or under an intangible (e.g. a receivable, rights to payment of funds credited to a bank account, proceeds under an independent undertaking). Most of the rules relating to the relationship between the grantor and the secured creditor on the one hand, and the debtor on the obligation (what this Guide calls third-party obligors) on the other, are mandatory but some are non-mandatory. The rights and obligations of third-party obligors are discussed in detail in chapter IX.

62. This chapter focuses on the pre-default rights and obligations as between the assignor and the assignee. Consistent with the principle of party autonomy, most States take the position that the parties themselves should determine their mutual pre-default rights and obligations. Hence, the majority of the rules relating to these rights and obligations are non-mandatory. Articles 11-14 of the United Nations

Assignment Convention do, however, provide for a number of mandatory rules in the case of international assignments.

63. The basic principle in this field can be stated succinctly and is typically found in the national law of most States. It provides that, because the security agreement may refer to an ongoing relationship between the parties, unless they otherwise decide, they should be bound by their own practices and usages. This Guide adopts the idea that the agreement between the parties is the primary source of their mutual rights and obligations and that absent a contrary agreement, their own established practices and usages will also be binding on them (see A/CN.9/631, recommendation 110).

64. Some of the most important parts of the agreement between the assignor and the assignee relate to the representations that the assignor makes to the assignee. In the normal case, it is presumed that (a) the assignor has the right to assign the receivable; (b) the receivable has not been previously assigned; and (c) the debtor of the receivable does not have any defences or rights of set-off that can be set up against the assignor. In other words, if the assignor has doubts about any of these matters, it must explicitly mention these in the agreement or must explicitly state that it makes no representations to this effect. In all events, in parallel with the grantor's pre-default obligations in respect of tangible property, the assignor must take all reasonable steps necessary to preserve the value of the receivable. This means that it must continue to ensure that it retains the legal right to collect on the receivable. On the other hand, unless the assignor specifically warrants otherwise, it is presumed that the assignor does not warrant the actual capacity of the debtor of the receivable to pay. These various obligations are presented in the form of non-mandatory rules in the national law of most States and are recommended as such in this Guide (see A/CN.9/631, recommendation 111).

65. As the value of the assigned receivable consists of payment made by the debtor of the obligation, and as the debtor of the receivable is only obliged to pay the assignee if it actually knows of the assignee's rights (see A/CN.9/631, recommendations 114 and 115), it is important to maximize the capacity of the assignee to make the debtor aware of the assignment. For this reason, many States provide that either the assignor or the assignee may notify the debtor and give instructions about how payment is to be made. Nonetheless, in order to prevent conflicting instructions from being given, it is normally the case that thereafter, only the assignee may direct the debtor as to the manner and place of payment.

66. There may, of course, be situations where both the assignor and the assignee (or just one of them) do not wish the debtor of the receivable to know of the assignment. This desire may relate to particular features of the business in question or to general economic conditions. For this reason, States usually provide that the assignor and assignee may agree to postpone notifying the debtor of the receivable that the assignment has occurred until some later time. Until such notice is given, the debtor of the receivable will continue to pay the assignor according to the agreement between them or any subsequent payment instructions. Where a party (usually the assignee) is in breach of an obligation not to notify this should not prejudice the debtor of the receivable. The debtor may pay according to the instructions given and receive a discharge for amounts so paid (see A/CN.9/631, recommendation 116). Nonetheless, many States also provide that, unless the assignor and assignee otherwise agree, such a breach may give rise to liability for

any resulting damages. This Guide recommends that these general principles govern notification of the assignment to the debtor of the receivable (see A/CN.9/631, recommendation 112).

67. Because the right to payment is the actual object of the security, it is important to specify the effect of any payment made by the debtor of the receivable (whether to the assignor or the assignee) on their respective rights. Many States have enacted non-mandatory rules to govern the outcome of payments made in good faith that may not actually be made according to the intention of the assignor or assignee. For example, even if no notification of the assignment is given to the debtor of the receivable, payment might actually be made to or received by the assignee. Given the purpose of the security right in the receivable, it is more efficient that the assignee be entitled to keep the payment, applying it to a reduction of the assignor's obligation. Similarly, if payment is made to the assignor after the assignment has been made, and again regardless of whether the debtor of the receivable has received notice, the assignor should be required to remit the payment received to the assignee. Likewise, once notice has been given, if part of the payment obligation is to return property to the assignor, States often provide that this property should be handed over to the assignee. In all these cases, however, the rules adopted by many States are non-mandatory and, as a result, the assignor and assignee might provide for a different outcome in their agreement.

68. In the case of multiple assignments of a receivable, the debtor of the receivable may receive multiple notifications and may be uncertain as to which assignee has the best right to payment. Sometimes, the payment is made in good faith to an assignee that has a lower priority. In such cases, States usually provide that the assignee with prior rank should not be deprived of its rights to obtain payment and where the payment obligation involves the return of property to the assignor, to receive this property as well. In all cases, however, the assignee may only retain payment to the extent of its rights in the receivable, so that if the payment made by the debtor of the receivable is greater than the outstanding indebtedness of the assignor, the assignee must remit the excess to the person who is entitled to it (the next lower-ranking assignee or the assignor as the case may be). Consistent with its general approach to allocating pre-default rights and obligations as between assignor and assignee, this Guide recommends that these general principles govern cases where payment has been made in good faith to a person not actually entitled to receive it (see A/CN.9/631, recommendation 113).

69. These non-mandatory rules relating to pre-default rights and obligations of assignors and assignees of intangible property help to structure the relationship between them. In many ways, they paradigmatically reflect what non-mandatory rules are meant to accomplish, which is why they are explicitly stated in the national law of many States. For this reason also, this Guide recommends that they be included in any law relating to secured transactions so as to facilitate the efficient assignment and collection of receivables, while nonetheless permitting assignors and assignees to structure their own transactions differently so as to meet their own needs and wishes.

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*.]