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Addendum

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VII. Priority of a security right

A. General remarks

1. Introduction

(a) The concept of priority

1. The concept of priority is at the core of every successful secured transactions regime. It is the primary means by which States resolve conflicts among competing claimants to a debtor's property (for the definitions of the terms "priority" and "competing claimant", see Introduction, section B, Terminology). In a secured transactions regime relating to movable assets, the concept is reflected in the set of principles and rules governing the extent to which a secured creditor may derive the economic benefit of its right in an encumbered asset in preference to any other competing claimant.

2. The logic and limits of the concept of priority are best understood against the backdrop of a State's general law of debtor-creditor relations. In some States, debtor-creditor law does not directly concern itself with the relationship among a debtor's various creditors; it only deals with the relationship between the creditor and its debtor. Upon default, a creditor can obtain a judgement against its debtor and then simply seize and sell its debtor's assets to pay the amount owed based on the judgement. In these States, the concept of priority (that is, where it is necessary to determine which of two or more claimants has the best right in an asset) arises only when a competing claimant contests a creditor's right to realize upon one or more of its debtor's assets. This might occur, for example, where a creditor seizes property found on its debtor's premises that may in fact belong to a third party.

3. In most States, however, debtor-creditor law is more broadly cast. It is also more explicit about how relationships among all of a debtor's creditors are to be regulated. Two general principles usually govern these relationships. First, the law typically provides that the assets of a debtor are the "common pledge" (sometimes knows as the "sizeable estate") of its creditors: all a debtor's assets may be seized and sold to satisfy an obligation confirmed by a judgement in favour of any one creditor; however, if other creditors have also obtained a judgement and join the seizure, the proceeds of sale are used to satisfy the claims of all creditors. Second, in the event that there is not enough money generated by the sale of assets to pay all creditors in full, their claims are discounted proportionally and they are paid pro rata (i.e. creditors share equally in the proceeds of sale in proportion to the respective amounts of their claims).

4. Although both of the principles mentioned in the preceding paragraph are part of the law of most States, the debtor-creditor law in these States has evolved well beyond these principles so as to permit particular creditors to obtain a preference over other creditors. In other words, in most States, these two principles govern all debtor-creditor relationships only where one or more creditors have not contracted with their debtor for a preference. For example, in many States, creditors use devices such as retention-of-title or a sale with a right of redemption either to prevent certain assets from becoming part of, or to withdraw certain of a debtor's assets from, the common pledge otherwise available to all creditors. Having done so, these creditors can enhance the likelihood of receiving full payment of any

obligations owed to them since they no longer have to share the economic value of those assets with competing claimants. In addition, in most States, certain creditors are authorized to obtain a preferential right in the distribution of the proceeds of a sale in realization of their claims. This preference can arise either by virtue of a legislatively determined preference (such as that often awarded to repairers of assets, unpaid sellers of assets and taxing authorities) or by entering into a contract to obtain a security right in specific assets of the debtor. In these cases, the right of certain creditors to be paid in preference to other creditors directly enhances the likelihood that the former creditors will receive full payment of their claims, since competing claimants will be paid only after the claims of preferred creditors have been fully satisfied. Sorting through the consequences of these techniques to obtain a preference over competing claimants is one of the key purposes of rules governing priority.

5. States take different general approaches to creating a set of priority rules. In some States, the concept is given a rather narrow meaning. It is used only in reference to competitions between claimants that have obtained a preference through a disruption of the principle of creditor equality. In these States, competitions involving claimants whose claims are limited to one or more assets of the debtor (notably sellers that have retained title and subsequent acquirers of a debtor's assets) are not normally characterized as priority conflicts. They are resolved, first and foremost, by determining whether the claimant or the debtor has title to the asset in question. Moreover, in these States, questions of priority usually arise only when a creditor seeks to enforce its claim by realizing upon its debtor's assets; the concept of priority has no material relevance prior to that time.

6. In other States, the term priority has a broader scope. It is used in reference to any competition between claimants that have proprietary rights in the assets (or ostensible assets) of their debtor (even assets that the debtor may not actually yet own). For example, the conflict between a seller that has retained title to an asset, a third party to whom the debtor has purportedly sold the asset and a judgement creditor of the purchaser with a right in the asset is characterized as a priority conflict. Furthermore, in these States, the concept of priority governs the relationship between competing claimants even before a debtor is in default. A competition between the transferee of a claim and a creditor that is collecting the claim is viewed as a priority competition, even though the debtor may not yet be in default towards the collecting creditor.

7. The Guide recommends that States adopt a fully integrated (or unitary) approach to security rights as a general organizing framework. Except in connection with the non-unitary approach to acquisition financing (see chapter XI on acquisition financing), whether a creditor seeks to obtain a preference by means of either the principle of the common pledge or the principle of creditor equality, the particular means by which it does so will be a matter for secured transactions law (see chapter III, Basic approaches to security, recommendation 11). For this reason, in the present chapter the term priority is used in the broader sense just outlined. All competitions between a secured creditor and any other claimants that seek to enforce rights in an encumbered asset are treated as priority conflicts.

(b) The domain of priority: types of priority competition

8. Before examining why the concept of priority is so important (see paras. 12-16 below), the various situations in which questions of priority arise are discussed so as to explain the relevant context. Issues of priority typically arise in two main contexts, both of which presume that at least one of the competing claimants is a secured creditor.

9. Most commonly, priority issues become relevant at the point of enforcement of security rights, such as where the grantor of a security right in an encumbered asset defaults on its secured obligation, and where the value of the encumbered asset is not sufficient to satisfy the obligations owed to the enforcing creditor and all other competing claimants asserting a right in the asset. In this situation, the secured transactions law must determine how the economic value of the asset is to be allocated among them. Often, the competing claimant will be another secured creditor of the grantor. A typical example is where a grantor has granted security rights in the same asset to two different lenders. However, in many cases, the competing claimant will be the holder of another type of proprietary right, such as a right created by statute (e.g. a preferential creditor). Still another example is where a grantor is in default to a secured creditor and an unsecured creditor of the grantor has obtained a judgement against the grantor and has taken steps to enforce the judgement against assets encumbered by the security right.

10. Priority issues also arise where a third party asserts a claim to an encumbered asset that will, if successful, enable the third party to obtain a clear title to the asset (that is, free of all security rights in the asset and other competing claims to the asset). A typical example is where a grantor creates a security right in favour of a lender retaining possession of the asset and then sells the encumbered asset to a third party. In this situation, the secured transactions law must determine whether the buyer of the asset acquires title to the asset free of the lender's security right. Another example is where a grantor creates a security right in an asset in favour of a lender and then leases or licenses the asset to a third party. Here, the secured transactions law must determine whether the lessee or licensee may each enjoy its property rights under the lease or license unaffected by the lender's security right. Yet another example arises where the insolvency representative in the grantor's insolvency proceedings claims the assets encumbered by a creditor's security right for the benefit of the insolvency estate.

11. In all of the cases just mentioned, priority is an issue only if security rights are effective against third parties (as to the distinction between effectiveness between the parties and effectiveness as against third parties, see chapter IV on the creation of a security right). While some States attach priority consequences to certain rights that may not be "fully" effective against third parties, other States draw a sharp distinction between rights that are effective against third parties and those that are not. In these States, security rights that are not effective against third parties have the same ranking, both as against each other and as against the rights of ordinary unsecured claimants. Moreover, competing claimants that benefit from a preferred status under other law (for example, providers of services such as repairers and those that are given a legislative preference) or that acquire assets from the grantor will always have priority over a security right that has not been made effective against third parties. It should be noted, however, that even if security rights are not effective against third parties and produce no priority consequences, they are,

nevertheless, effective and enforceable against the grantor (see recommendation 30 and chapter VIII, Rights and obligations of the parties to a security agreement).

(c) The importance of priority rules

12. For a number of reasons, it is widely recognized that effective priority rules are fundamental to promoting the availability of secured credit.

13. To begin, the most critical issue for a secured creditor is what the priority of its security right will be in the event it seeks to enforce the security right either within or outside of the grantor's insolvency. More specifically, the question is how much might the secured creditor reasonably expect to derive from the sale of encumbered assets. This question is especially important where the encumbered assets are expected to be the creditor's primary or only source of repayment. To the extent that the creditor is uncertain about the priority of its prospective security right at the time it is evaluating whether to extend credit, it will place less reliance on these encumbered assets as a guarantee of repayment. This uncertainty about how much can be realized upon the sale of the assets may induce the creditor to increase the cost of the credit (for example, by charging a higher interest rate) or to reduce the amount of the credit (by advancing a smaller percentage of the value of the encumbered assets). In some cases, it may even cause the creditor to refuse to extend credit altogether.

14. To minimize this uncertainty (and thereby to promote secured credit), it is important that secured transactions laws include clear priority rules that lead to predictable outcomes in any competition between claimants to the encumbered assets. In addition, because security rights have no value to secured creditors unless they are enforceable in the grantor's insolvency proceedings, it is important that these outcomes are respected by the insolvency law of a State to the maximum extent possible (see chapter XIV on the impact of insolvency on a security right, paras. 13 and 59-63). This is especially true because, in many cases, a default towards a secured creditor may be concurrent with defaults towards other creditors, triggering insolvency. Clear priority rules function not only to resolve disputes, but also to avoid disputes by enabling competing claimants to predict how a potential priority dispute will be resolved. In this way, the existence of effective priority rules can have a positive impact on the availability and cost of secured credit, by allowing prospective creditors to feel more confident that they will be able to look to the encumbered assets in the event of their grantor's default (even if the grantor becomes subject to insolvency proceedings) and to calculate accurately the risks associated with the extension of credit to a given borrower.

15. Well-conceived priority rules can also have another positive impact on the overall availability of secured credit. Many banks and other financial institutions are willing to extend credit based upon security rights that are subordinate to one or more other higher-ranking security rights held by other secured creditors, so long as they perceive that there is residual value in the grantor's assets (over and above the other secured obligations) to support their security rights and can clearly confirm the precise priority of their security rights. This presupposes that the prospective creditor is able to determine the maximum amount secured by the higher-ranking security rights, either by communicating with the holders of the other security rights or, in States that require a statement of the maximum amount for which a security right encumbers an asset, by consulting the registered notice in the general security

rights registry (see para. 141 below and recommendation 57, subparagraph (d)). Alternatively, in situations where the prospective secured creditor is unable to satisfy itself that sufficient residual value exists to support the proposed new grant of credit, that secured creditor may be able to create sufficient value by negotiating a subordination agreement with one or more higher-ranking secured creditors, by which the higher-ranking creditors would subordinate their security rights in particular assets to the proposed new security right (see paras. 130-133 below and recommendation 75). The higher-ranking secured creditors may be willing to subordinate their security rights because they believe that the proposed new extension of credit will help the grantor's business, thereby enhancing the likelihood that their higher-ranking claims will be paid.

16. In both of these situations, the likelihood that another creditor will extend credit to a grantor is significantly increased in a State where there are clear priority rules that enable creditors to assess their priority with a high degree of certainty. In addition, clear and well-conceived priority rules facilitate the granting of multiple security rights in the same assets. In so doing, they enable a grantor to maximize the value of its assets that can be used to obtain credit.

(d) Outline of the chapter

17. This chapter discusses, in section A.2, general approaches to drafting priority rules, and in section A.3, the various means by which priority may be determined. The chapter then turns to a review of the key priority rules that should be part of a modern secured transactions regime. Section A.4 considers the relationship among the various competing claimants. Section A.5 addresses the scope and interpretation of priority rules. Section B reviews special priority rules that apply only to certain specific categories of assets. The chapter concludes, in section C, with a series of recommendations.

2. Approaches to drafting priority rules

18. States face a number of key policy choices when drafting priority rules. Initially, they must determine the scope of the priority regime. The first question is whether it should cover only competitions between various creditors of personal obligations or embrace competitions between all persons that claim rights in or in relation to a debtor's assets or ostensible assets. For reasons given above (see paras. 1-7), the Guide adopts the position that the priority regime should encompass priority competitions among all potential competing claimants.

19. States must then decide how these priority rules should be organized and drafted. Several approaches are possible, although they broadly reflect alternative tendencies in legislative drafting.

20. One approach is to develop priority rules as a set of general principles for courts to interpret and apply in resolving particular conflicts. When States adopt such an approach, especially in conjunction with the enactment of a new secured transactions regime of the fully integrated type that is recommended in the Guide, a tremendous burden is placed upon courts to flesh out the detailed application of these general principles. Not only must judges quickly master the underlying logic of the new regime, they must also ascertain and internalize market practices so as to develop specific rules that are predictable and efficient. Moreover, there may be a

considerable period of time before a sufficient number of judicial decisions on a sufficient range of issues have been rendered so as to provide real certainty as to the operation of the priority principles in practice.

21. Another approach is to develop a large number of detailed priority rules meant to govern all the possible situations involving competing claimants that can be imagined. Where this approach is taken, especially in States that have previously developed priority regimes through broad principles derived from first determining ownership of assets subject to competing claims, a comprehensive system of specific rules can look extremely complex and difficult for lawyers and judges to use.

22. Yet another approach is to develop and organize priority rules in a coherent whole as a series of more general principles followed by specific applications of these principles to commonly occurring situations. Such an approach can provide both clarity and a high degree of certainty about any particular priority conflict. This is the approach recommended by the Guide.

23. In selecting one or the other approach, a State must consider the overall objectives it is seeking to achieve. To recall, the Guide aims to present a regime of secured transactions that envisions non-possessory security rights over a range of tangible and intangible assets that in many States have not previously been capable of being encumbered or have not been capable of being encumbered by more than one security right at a time (see recommendation 2 (a)). Moreover, the Guide takes a fully integrated approach to transactions that, regardless of their name, are intended to secure the performance of an obligation (see recommendation 11). Finally, the Guide recognizes a variety of methods by which security rights may be made effective against third parties (see recommendations 32 and 34-36). For all these reasons, the Guide recommends that States adopt the third approach to drafting their priority rules.

24. Following this logic, a modern secured transactions regime should incorporate a set of detailed and precise priority rules that: (a) are comprehensive in scope; (b) cover a broad range of existing and future secured obligations; (c) apply to all types of encumbered asset, including after-acquired assets and proceeds; and (d) provide ways for resolving priority conflicts among a wide variety of competing claimants (for example, secured creditors, transferees, service providers and judgement creditors). Such an approach to priority rules encourages prospective creditors to extend secured credit by giving them a high degree of assurance that they can predict how potential priority disputes will be resolved. The remaining sections of this chapter specify what issues these detailed rules should address and how they should be formulated.

3. Different bases upon which priority may be determined

25. In a modern secured transactions regime, because priority rules are meant to govern the rights of the holder of a security right as against the rights of one or more third parties, they are closely correlated with the different methods through which third-party effectiveness of the security right may be achieved. In view of the significant importance the Guide places on achieving third-party effectiveness, it takes the general approach that no secured creditor may assert priority over a

competing claimant unless the security right has been made effective against third parties. Only in such cases can a question of priority arise.

26. This section briefly restates the various methods for achieving third-party effectiveness that have been adopted in various States, indicating in each case what basic priority principles will apply when third-party effectiveness has been achieved using that method. It reviews, in turn, third-party effectiveness deriving from: (a) registration of a notice in a general security rights registry; (b) possession of the encumbered asset by the secured creditor; (c) a control agreement; (d) registration in a specialized registry or notation on a title certificate; (e) the creation of the security right; and (f) notification to a third-party obligor.

(a) Priority where third-party effectiveness is based on registration

27. As discussed above (see chapter V on the effectiveness of a security right against third parties, paras. […], and chapter VI on the registry system, paras. […]), one of the most effective ways to provide creditors with the means to determine their priority with a high degree of certainty at the time they extend credit is to base priority on the use of a public registry.

28. In most States in which there is a reliable system for registration of notices with respect to security rights, the general principle is that priority is accorded to the right referred to in the earliest-registered notice (often referred to as the "first-to-register priority rule").

(i) Registration of a notice prior to the creation of a security right

29. In many States, registration traditionally has been seen as a step to achieve third-party effectiveness that is taken once a security right has been made effective between the parties. This means that the registration publicizes and confirms a right that already exists or arises concurrently with the registration (see the discussion in chapter V on the effectiveness of a security right against third parties, paras. […]). An example is a legal system in which a security right becomes effective against third parties when the entire security agreement is registered. In some States, however, the approach is not to register a right that already exists, but rather to register a notice relating to a right that may or may not yet exist. The registration does not confirm that the right has actually been created, but rather that it either has been created or may be created. As a result, in these States, the first-to-register priority rule can apply even if one or more of the requirements for the creation of a security right have not been satisfied at the time of registration.

30. Such an approach avoids the need for a creditor that has already registered a notice to search the registration system again after all remaining requirements for the creation of its security rights have been satisfied. It provides the creditor with certainty that, once it registers a notice of its security right, other rights with respect to which a notice is registered later in time will not have priority over its security right. For example, Creditor A can register its notice, conduct a search of the registry to determine that no notice of security right has been registered, and then extend credit with the assurance that its security right will have a first-ranking priority, even if Creditor B registers a notice of a competing security right during the period between Creditor A's registration and Creditor A's extension of credit. Moreover, other existing or potential creditors are also protected under this rule

because the registered notice will warn them about potential security rights and they can then take steps to protect themselves (such as by requiring personal guarantees or security rights with lower-priority ranking in the same assets or higher-priority ranking security rights in other assets). This is the approach taken by the Guide (see recommendation 73 (a)).

(ii) Attenuations with respect to the first-to-register rule

31. In many States where priority is based on the first-to-register rule, that rule is attenuated in the case of what have been called "grace periods" for registration. Grace periods permit retroactivity in the third-party effectiveness of a security right if registration of a notice takes place within a short period of time following the creation of a security right. In these cases, priority will be determined according to the date of creation rather than the date of registration of the notice. As a result, a security right that is created first but registered second may nevertheless have priority over a security right that is created second but registered first, as long as the notice with respect to the later-created security right is registered within the applicable grace period. In these cases, until the grace period expires, the registration date is not a reliable measure of a creditor's priority ranking (see generally chapter XII on acquisition financing, paras. […]).

32. Creditors seek to protect themselves against this risk in a number of different ways. They may delay extending credit to the grantor until the applicable grace period has expired. However, this solution has the drawback that it also delays the extension of credit to the grantor. Alternatively, creditors may rely on a representation of the grantor that it has not granted any competing security rights in the same encumbered assets. This solution is also not ideal, because it provides the creditor with only a claim for damages in the event the representation is untrue. In order to avoid undermining the certainty achieved by the first-to-register rule, States generally restrict the use of grace periods to rare circumstances, such as: (a) acquisition financing; or (b) circumstances in which registration before or concurrently with creation is not logistically possible.

(iii) Exceptions to the first-to-register rule

33. The first-to-register rule cannot be absolute. In modern secured transactions regimes, there are two main types of exception. Sometimes States provide that a security right may be automatically effective against third parties upon its creation without the need to register a notice. This exception is most often found in respect of security rights in consumer goods (for the definition of the term "consumer goods", see Introduction, section B, Terminology). In these cases, the priority of the security right is determined by reference to the time of its creation (see paras. 45 and 46 below).

34. In addition, many States have adopted an exception to the first-to-register priority rule for security rights that have been made effective against third parties by a method other than registration of a notice in the general security rights registry. So, for example, where a notice of the security right happens to be registered second in the general registry, but has also been registered first in a specialized title registry or noted on a title certificate, States typically award priority to the order of registration in the specialized registry or to the notation on the title certificate (see paras. 41-44 below). Likewise, where a security right is registered second in the

general registry, but the encumbered asset is a negotiable instrument in the possession of a creditor (see paras. 35-38 and 155-157 below), a negotiable document in possession of a creditor (see paras. 168-170 below), or a right to payment of funds credited to a bank account that has been made subject to a control agreement (see paras. 158-164 below), priority is usually given to the possessor of the negotiable instrument or negotiable document, or the beneficiary of the control agreement.

(b) Priority where third-party effectiveness is based on possession

35. As already discussed (see chapter IV on the creation of a security right, paras. […], and chapter V on the effectiveness of a security right against third parties, paras. […]), possessory security rights traditionally have been an important component of the secured transactions laws of most States. In recognition of this fact, even in States that have established a general security rights registry, security rights in tangible assets may also be made effective against third parties through possession by the creditor.

36. In these States, notwithstanding the general principle that priority goes to the first creditor to register a notice in the general security rights registry, priority may also be established based on the date that the creditor obtained possession of the encumbered asset, without any requirement of registering a notice. Moreover, in many of these States, a third party may have actual possession of the assets, and multiple secured creditors may agree among themselves that the third party holds for all of them, with priority determined by the respective dates on which possession on behalf of each creditor is established. In such cases, possession for each of the creditors may begin on a different date, and therefore the priority among the creditors will be fixed according to the date on which possession on their account commenced. However, whenever the priority dispute is among security rights that have achieved third-party effectiveness by possession (regardless of whether possession is held by the secured creditor or by an agent on behalf of one or more secured creditors), priority generally is determined by the order in which third-party effectiveness was achieved (see recommendation 73, subparagraph (b)).

37. As a result of the use of the date of possession to establish priority, it is necessary for States to provide a rule to govern priority as among creditors that have registered a notice in the general security rights register and creditors that have obtained possession. The usual rule is that priority is determined by the order in which: (a) the notice was registered in the general security rights register; and (b) possession of the encumbered asset was obtained (see recommendation 73, subparagraph (c)). For example, if Creditor A registered a notice on Day 1, Creditor B took possession on Day 2, Creditor C arranged for Creditor B to also hold on its behalf on Day 3, and Creditor D registered a notice on Day 4, the priority ranking of the creditors would be A, B, C and D.

38. Notwithstanding its importance, priority based on possession has the disadvantage that, because possession is often not a public act, the holder of a security right that relies on possession to establish priority will have the burden of establishing precisely the time at which it obtained possession. Despite this disadvantage, however, priority based on possession is commercially useful in the case of certain assets such as negotiable instruments (e.g. a cheque, bill of exchange or promissory note) or negotiable documents of title (e.g. a bill of lading or

warehouse receipt). In these cases, possession by the secured creditor can prevent prohibited dispositions of the encumbered asset by the grantor. In addition, as noted, many States also provide that a security right in these types of asset that becomes effective against third parties by possession is generally accorded priority over a security right made effective against third parties by registration of a notice, even if the registration occurs first (see recommendations 98, 105 and 106; see also paras. 155-157 and 168-170 below).

(c) Priority where third-party effectiveness is based on control

39. In some States, third-party effectiveness of a security right in certain types of intangible asset may be achieved by means of "control" (see Introduction, section B, Terminology). In most cases where States permit third-party effectiveness to be established by control, priority is typically accorded to a secured creditor that obtains control with respect to the encumbered asset, regardless of whether that occurs before or after the rights of competing claimants in the asset arise. For example, where the asset is the right to the payment of funds credited to a bank account, the priority system generally awards priority to a security right made effective against third parties by control over a security right made effective against third parties by a different method (see recommendation 100; see also paras. 158-164 below).

40. In the case of certain types of intangible asset, such as the right to receive the proceeds under an independent undertaking, some States provide that control may be the exclusive method for achieving third-party effectiveness. Where this is the case, there is no need to provide for priority rules to govern conflicts between third-party effectiveness based on control and third-party effectiveness achieved by any other means (see recommendation 104; see also paras. 166 and 167 below).

(d) Priority where third-party effectiveness is based on registration in a specialized registry or notation on a title certificate

41. In many States, a security or other right (such as the right of a buyer or lessee of an encumbered asset) may be registered in a specialized registry, or may be noted on a title certificate. Originally, the function of some specialized registries or title notation systems was only to protect buyers of assets subject to the registry or system by confirming that the seller actually had title to the asset being sold. However, some specialized registries, such as ship and aircraft registries, traditionally have also served the broader purpose of protecting all types of transferee of rights in the designated assets, including holders of security rights. More recently, there has been a trend for specialized registries and title notation systems to cover this broader purpose (see recommendation 38).

42. When an asset is subject to a specialized registry or title notation system, the question arises as to which right of the several rights mentioned in the registry or notation system has priority. In most cases, States that have adopted such registries or systems provide that rights rank in the order in which they are registered. Such a security right has priority over a security right that is subsequently registered in the specialized registry or noted on a title certificate.

43. When a specialized registry exists, it is also necessary to determine the priority as between the right registered in the specialized registry or noted on a title certificate, on the one hand, and a right registered in the general security rights

registry or a right that has been made effective against third parties by possession or some other means, on the other hand. In most such States, a right registered in a specialized registry or noted on a title certificate has priority over any security rights not so registered or noted on a title certificate. A similar rule is usually also adopted by these States in respect of transferees, lessees and licensees of rights in assets subject to a specialized registry or title notation system. With only minor exceptions, the rights of a transferee, lessee or licensee in such assets will be subordinate to any rights registered in the specialized registry or noted on the title certificate (see paras. 70-94 below and recommendation 75).

44. The reason for the approach just described is to enable transferees of such assets to enhance efficiency by permitting a person to search in only one place (i.e. the specialized registry or the title certificate). It is important to note, however, that the priority rules discussed above apply only to the extent that the specialized registration or notation regime does not itself provide for different priority rules.

(e) Priority where third-party effectiveness is based on creation of the security right

45. In States in which there is no registration system for security rights, third-party effectiveness often is automatic and is achieved upon creation of the security right. Even in States that have adopted registration systems, third-party effectiveness of rights in certain types of asset, such as consumer goods, is sometimes automatic. In these States, the priority of a security right is usually determined by comparing the time when the security right is created with the time a notice with respect to the competing security right is registered in the general security rights registry or the competing security right has been made effective against third parties by some other method (see paras. 59-61 below).

46. The advantage of and rationale for automatic third-party effectiveness is to relieve certain claimants of the need to take further steps to ensure the priority of their rights. In the case of consumer goods and assets of small value, the idea of linking priority to creation can, consequently, lead to efficient outcomes. However, there are situations where automatic third-party effectiveness can lead to inefficiencies in the priority system. For example, where States permit automatic third-party effectiveness in relation to common transactions such as retention-of-title sales and assignments of receivables for security purposes, other claimants are required to undertake costly and time-consuming inquiries (typically relying on less objective evidence such as representations of the grantor or information generally available in the market) to determine the existence and priority of non-possessory security rights.

(f) Priority where third-party effectiveness is based on notification to a third-party obligor

47. Most of the bases for determining priority noted above contemplate situations involving tangible assets such as equipment and inventory. Where security rights are created in receivables or other rights to payment, States typically provide that priority will be determined according to the date on which a notice is registered in the general security rights registry or, if some other method for achieving third-party effectiveness is at issue, the date on which third-party effectiveness is achieved. In other States, however, third-party effectiveness of a security right in a receivable and priority among competing claimants is based on the time that the

debtor of the receivable is notified of the existence of the security right (for the definition of "debtor of the receivable", see Introduction, section B, Terminology).

48. The advantage of determining priority on this basis is that it simplifies the task of the debtor of the receivable in determining to whom payment should be made. One disadvantage is that it can foster uncertainty for prospective secured creditors because they cannot know if, and when, a competing secured creditor has given notice of its security right to the debtor of the receivable. A second disadvantage is that this lack of certainty may lead claimants to immediately enforce their rights. This result deprives the grantor of a source of income with which to operate its business.

(g) Priority legislatively determined according to the nature of the creditor's claim

49. In many States, certain claims are given a priority solely on the basis of the nature of the claim, regardless of the date on which the claim arose or was made effective against third parties. In these cases, States enact a ranking of priorities that is applicable to all competitions between claimants. For example, tax claims, claims for contributions to social welfare programmes and employee wages are sometimes given a first-ranking priority, even over security rights that have previously been made effective against third parties. Moreover, in these States, there is typically a sub-ranking under which, for example, legal costs may outrank tax claims, which may outrank claims for social welfare programmes, which in turn may outrank employee's claims for wages. Sometimes these rights require registration, and sometimes they do not. But in both cases, priority is determined according to a legislatively established ranking and not according to any scheme based on the time the security right may have been created or made effective against third parties (see paras. 95-98 below).

50. The advantage of these legislatively determined priorities is that they provide some measure of protection for claimants that might not otherwise have the negotiating power to obtain a security right by agreement. The disadvantage is that, even when they must be registered to be effective against third parties, they usually trump pre-existing security rights. In consequence, secured creditors cannot, at the time they take a security right, precisely determine the ranking or amount of the legislatively determined priorities. This uncertainty inevitably is likely to drive up the cost and reduce the availability of secured credit. In recognition of this fact, States usually limit the nature and amount of such claims (e.g. to "wages in an amount not to exceed a certain amount per employee" or "up to a certain number of months of unpaid wages").

4. Rules for determining priority as among competing claimants

51. The general principles reviewed to this point form the basic structure of a priority regime in relation to: (a) the different means by which a priority system can be organized; and (b) the scope of the priority of the security right, particularly as this relates to future obligations, after-acquired assets and proceeds. The discussion that follows focuses on the specific priority rules to govern the rights of competing claimants.

(a) Priority as among secured and unsecured creditors

52. Generally, States provide that all security rights that have been made effective against third parties have priority over the rights of unsecured creditors. It is generally accepted that giving secured creditors this priority is necessary to promote the availability of secured credit. Unsecured creditors can take other steps to protect their rights, such as charging a premium to account for their increased risk, monitoring the status of the credit, or requiring the debtor to pay interest on amounts that are past due. In addition, secured credit can increase the working capital of the grantor. Typically, advances made under a secured revolving working capital loan facility are the principal source from which a company will pay its unsecured creditors in the ordinary course of its business (see chapter II on the scope of application and other general rules, section F, Examples of financing practices covered). The principle that secured creditors have priority over unsecured creditors is central to the approach taken by the Guide, and underlies many of its recommendations (see, for example, recommendation 81).

53. In many States, the priority afforded to secured creditors over unsecured creditors is absolute. In some States, however, it is subject to an exception in favour of judgement creditors. The holder of an unsecured claim may obtain a right in the assets of a debtor by obtaining a judgement or provisional court order against the debtor. By registering the judgement in the general security rights registry, the judgement creditor is able to convert an unsecured claim into a secured claim that ranks according to the ordinary priority rules. Other States go further and provide that where an unsecured creditor has taken the steps required under applicable law to obtain a judgement or provisional court order, the proprietary rights it asserts may actually have priority over certain claims of a pre-existing secured creditor (see recommendation 81 and paras. 99-107 below).

(b) Priority as among competing security rights in the same encumbered assets

54. One of the key features of a modern secured transactions regime is the efficiency with which it resolves priority disputes among competing security rights in the same encumbered assets. Such priority disputes may involve security rights that are all made effective against third parties by registration of a notice in the general security rights registry, security rights that are all made effective against third parties by another method, or a combination of security rights that are made effective against third parties by registration and security rights that are made effective against third parties by registration and security rights that are made effective against third parties by another method. With very few exceptions, States provide, for all the various situations about to be reviewed, that priority will be determined on a temporal basis: first in time, first in right. The following paragraphs elaborate in detail how this central principle is usually applied to particular situations.

(i) Priority as among security rights made effective by registration of a notice in the general security rights registry

55. In most States that have a general security rights registry, priority among security rights that were all made effective against third parties by registration of a notice is determined by the order in which registration occurs, regardless of the order of third-party effectiveness and even if one or more of the requirements for

third-party effectiveness were not satisfied at that time. Only very limited exceptions to this principle are recognized (see paras. 63-67 below).

56. This approach may be illustrated by the following example. A Grantor applies to Bank A for a loan, to be secured by a security right in all of the Grantor's existing and future equipment (a security right that may be made effective against third parties by registration of a notice in the general security rights registry). On Day 1, Bank A conducts a search of the registry, which confirms that no other notices have been filed with respect to security rights of other creditors in the Grantor's equipment. On Day 2, Bank A enters into a security agreement with the Grantor, in which Bank A commits to make the requested secured loan. Also on Day 2, Bank A registers a notice of the security right in the general security rights registry, but it does not make the loan to the Grantor until Day 5. Thus, the security right of Bank A was created and became effective against third parties on Day 5 (i.e. the first time when all of the requirements for creation and third-party effectiveness were satisfied). However, on Day 3, the Grantor enters into a security agreement with Bank B, providing for a loan to be made by Bank B to the Grantor to be secured by a security right in the Grantor's existing and future equipment. On the same day (Day 3) Bank B registers a notice of the security right in the general security rights registry and grants the loan to the grantor. As a result, the security right of Bank B was created and made effective against third parties on Day 3. Under the first-to-register approach described above, Bank A's security right would have priority over Bank B's security right, regardless of the fact that Bank B's security right was created and made effective against third parties before Bank A's security right.

57. The primary reasons for this approach are: (a) to encourage registration of the notice as early as possible (which puts other potential creditors on notice of the security right); and (b) to provide certainty to secured creditors by enabling them to determine, before they extend credit, the priority of their security rights as against the rights of other secured creditors. In the above example, if Bank A searches the registry on Day 2 after it registers its notice and determines that there are no other notices in the registry that cover the relevant encumbered asset, Bank A can make its loan on Day 5 knowing with certainty that its security right will have priority over any other security right in the encumbered asset that may be made effective against third parties in the future, because the priority of Bank A's security right dates back to the time of its registration. By enabling Bank A to achieve this high level of certainty, the first-to-register approach can be a significant factor in promoting secured credit. Likewise, when Bank B searches the registry it will immediately know that it will have a subordinate position should Bank A extend credit and it will consequently be able to adjust the terms and conditions of the credit it extends accordingly.

58. This certainty would not exist under an alternative approach, adopted in some States, which accords priority to the first security right to become effective against third parties (third-party effectiveness requires both creation and registration or another method). There would always be a risk that another security right could achieve third-party effectiveness, and thus priority, after Bank A or B conducts its search of the record but before it makes its loan. This risk would exist regardless of how short that time period might be. For this reason, the Guide takes the position that the priority of competing claimants in such cases should be determined by the

date of registration of the notice, and not the date that the security right was either created or actually became effective as against third parties (see recommendation 73, subparagraph (a)).

(ii) Priority as among security rights made effective against third parties by means other than registration of a notice in the general security rights registry

59. In the case of a priority dispute among security rights made effective against third parties by means other than registration of a notice in the general security rights registry, States normally accord priority to the security right that is first made effective against third parties. This rule would apply, for example, in a situation where one security right in a particular encumbered asset was made effective against third parties by possession and another security right in the same asset was made effective automatically upon its creation.

60. In the case of security rights achieving third-party effectiveness by possession, there is normally no need for a "first-to-obtain-possession" rule analogous to the "first-to-register" rule noted above, as typically a secured creditor would obtain possession of the encumbered asset at the same time it extends credit and not before. In some States, however, it is possible for a creditor to exercise its possession through a third party. Where this is the case, more than one secured creditor may exercise possession in such a manner, and their relative priority is determined by the order in which they establish their possession through that third party. A similar result would be reached in the unlikely case that a bank or other financial institution entered into more than one control agreement. Priority would depend on the relative dates of the agreements.

61. In each of the examples given, consistent with the principle applicable to security rights made effective against third parties by registration of a notice in the general security rights registry, the Guide takes the position that the priority of competing claimants in such cases should be determined by the date that the security right became effective as against third parties (see recommendation 73, subparagraph (b)).

(iii) Priority as among security rights made effective against third parties by registration of a notice in the general security rights registry and security rights made effective against third parties by other means

62. In the case of priority disputes among security rights made effective against third parties by registration of a notice in the general security rights registry and security rights made effective against third parties by other means, States normally accord priority to the first security right to be registered or made effective against third parties. This rule represents a logical extension of the first-to-register rule, using the registry as a basis for enabling secured creditors to achieve a high level of certainty with respect to the priority of their security right. As the notice may be registered before the security right is created (an outcome not possible in respect of third-party effectiveness by possession or automatic third-party effectiveness upon creation), this rule also encourages the use of the registry for making security rights effective against third parties. The Guide adopts this principle as leading to the most efficient outcomes when third-party effectiveness is achieved by different means (see recommendation 73, subparagraph (c)).

(iv) Exceptions to the first-in-time principle for establishing priority as among competing secured creditors

63. The above-mentioned examples of how the first-in-time principle applies to the different situations where security rights are made effective against third parties by different means are nonetheless subject to limited exceptions. These exceptions reflect special priority rules relating to certain means for achieving third-party effectiveness, or certain types of transaction or encumbered asset, and are based on policy or practical considerations relating to such transactions or assets. Of the various means for achieving third-party effectiveness already mentioned, two in particular (i.e. registration in a specialized registry and control) often lead to special priority rules.

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

64. In many States, a security or other right (such as the right of a buyer or lessee of an encumbered asset) may be registered in a specialized registry, or it may be noted on a title certificate. Most of these States provide that rights rank in the order in which they are registered or noted (e.g. that such a security right has priority over a security right that is subsequently registered in the specialized registry or noted on a title certificate). In order to protect the integrity of such registers or notation systems, the Guide adopts a similar position (see recommendation 74, subparagraph (b)).

65. When a specialized registry exists, it is also necessary to determine the priority as between the right registered in the specialized registry or noted on a title certificate, on the one hand, and a right registered in the general security rights registry or a right that has been made effective against third parties by possession or some other means, on the other hand. In most such States, a security right or other right registered in a specialized registry or noted on a title certificate is accorded priority over a security right registered in a general registry or that achieves third-party effectiveness by a method other than registration in a specialized registry or notation on a title certificate, regardless of which occurred first. Once again, in order to protect the integrity of such registries and notation systems, the Guide adopts a similar position (see recommendation 74, subparagraph (a)).

b. Control agreements

66. A second exception is usually found in States that permit third-party effectiveness of security rights in certain types of intangible asset to be achieved by control. These States provide that, where a creditor obtains third-party effectiveness of a security right by control, priority is given to that security right, regardless of whether other creditors may have achieved effectiveness against third parties of their security rights by any other means (see paras. 158-164 and 166-167 below). In view of the special nature of security rights in rights to payment, the Guide adopts a similar position (see recommendations 100 and 104).

c. Other exceptions to the first-in-time rule

67. In addition to these situations, where third-party effectiveness is achieved by special means, exceptions to the first-in-time rule also arise in respect of certain types of transaction or certain types of encumbered asset. These types of transaction

or asset are: (a) acquisition security rights under both the unitary and non-unitary approach, and retention-of-title or financial lease rights under the non-unitary approach (see chapter XI on acquisition financing and recommendations 173-182 and 188-196); (b) cases in which third-party effectiveness of security rights in negotiable instruments, negotiable documents or money may be achieved by possession (see paras. 155-157, 165 and 168-170 below and recommendations 98, 99, 103, 105 and 106); (c) cases involving security rights in attachments (see paras. 115-120 below and recommendations 84-86); and (d) situations involving security rights in masses or products (see paras. 121-126 below and recommendations 87-89).

(c) Priority of rights of transferees, lessees and licensees of encumbered assets

(i) General

68. When a grantor transfers, leases or licenses tangible assets (other than negotiable instruments or negotiable documents) that are subject to existing security rights, the transferee, lessee or licensee has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold (subject to certain exceptions; see paras. 73-84 below). It is important that priority rules address both of these interests and that an appropriate balance be struck. If the rights of a secured creditor in particular assets are put at risk every time its grantor transfers, leases or licences them, their value as security would be severely diminished and the availability of secured credit based on their value would be jeopardized.

69. In most States, the starting point is the general principle that a transferee (including a buyer, exchanger, donee, legatee and other similar transferees), lessee or licensee of an encumbered asset takes its rights in the asset subject to an existing security right (the security right is said to encompass a "right to follow" or a *droit de suite*; see chapter V on the effectiveness of a security right against third parties; see also recommendations 31 and 76). In other words, the secured creditor may follow the asset in the hands of the buyer or other transferee, lessee or licensee. Exceptions to this general principle with respect to each of these types of transaction are discussed below.

(ii) Rights of buyers

70. As already mentioned (see chapter V on the effectiveness of a security right against third parties and chapter IV on the creation of a security right), when an encumbered asset is sold, the secured creditor retains its security right in the original encumbered asset and also obtains a security right in the proceeds of the sale (which may include cash, receivables, or even other assets in the case of transactions between barterers and exchangers (for the definition of "proceeds", see Introduction, section B, Terminology). In this situation, a question arises as to whether the security right in proceeds should replace the security right in the encumbered asset, so that the buyer takes its rights free of the security right.

71. It is sometimes argued that the security right should be extinguished upon a sale, on the premise that the secured creditor is not harmed by a sale of the assets free of its security right so long as it retains a security right in the proceeds of the sale. However, this result would not necessarily protect the secured creditor,

because proceeds are often not as valuable to the creditor as the original encumbered assets. In many instances, the proceeds may have little or no value to the creditor as security (e.g. a receivable that cannot be collected because the debtor of the receivable is not financially sound). In other instances, it might be difficult for the creditor to identify the proceeds and its claim to the proceeds may, therefore, be illusory. In addition, there is a risk that the proceeds, even if they are of value to the secured creditor, may be dissipated by the seller that receives them, leaving the creditor with nothing. Finally, it may be that another creditor may have taken a security right in the proceeds as original encumbered assets, and may have priority. This possibility is especially real in the case of receivables.

72. While States have adopted different approaches to achieving a balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession, most provide that the security right should survive the transfer even when the secured creditor is also able to claim a right in proceeds. This does not mean that the secured creditor will be paid twice. As a security right secures an obligation, the secured creditor that asserts rights in the assets and in the proceeds cannot claim or receive more than it is owed. The Guide takes the position that, as a general principle, the secured creditor should retain its security right in the original encumbered asset and also a security right in the proceeds of its sale or other transfer (see recommendations 19, 31, 39, 40 and 76).

73. This said, most States recognize two exceptions to the general principle that a security right in an asset continues to encumber the asset after its sale, and the Guide does also. The first exception relates to situations in which the secured creditor expressly authorizes the sale free of the security right (see recommendation 77, subparagraph (a)). A secured creditor may authorize such a sale, for example, because it believes that the proceeds are sufficient to secure payment of the secured obligation or because the grantor gives the secured creditor other assets as security to make up for the loss of the sold asset. It should be noted, however, that this exception does not apply to situations in which the secured creditor authorizes the sale, but does not authorize the grantor to sell free of the security right. In these situations, the buyer generally takes title to the asset subject to the security right.

74. The second exception refers to situations in which the authorization by the secured creditor to sell the assets free of the security right is inferred, because the encumbered assets are of such a nature that the secured party expects them to be sold free of the security right, or where it is in the best interest of all concerned parties that they be sold free of the security right. States have framed this second exception in a number of different ways, as described in the following paragraphs.

a. The ordinary-course-of-business approach

75. A common approach, taken in many States, is to provide that sales of encumbered assets consisting of inventory made by the grantor in the ordinary course of its business will result in the automatic extinguishment of any security rights that the secured creditor has in the assets without any further action on the part of the buyer, seller or secured creditor. The corollary to this rule is that when a sale of inventory is outside the ordinary course of the grantor’s business, or when the sale relates to an asset other than inventory, the exception will not apply; such a sale does not extinguish the security right and the secured creditor may, upon a

default by the grantor, enforce its security right against the encumbered asset in the hands of the buyer (unless the secured creditor has authorized the sale free of the security right). Where the security agreement so provides, the sale itself may constitute a default entitling the secured creditor to enforce its security rights; otherwise, the secured creditor cannot do so until default has occurred.

76. Under this approach, two requirements must be satisfied for the encumbered asset to be sold free of the security right. The first requirement is that the seller of the asset must be in the business of selling assets of that kind; the encumbered asset cannot be something that the seller does not typically sell. In addition, the sale cannot be concluded in a manner different than the manner typically followed by the seller, such as a sale by the seller outside of its typical distribution channel (e.g. if the seller normally sells only to retailers and the sale at issue is to a wholesaler). The second requirement is that the buyer must not have knowledge that the sale violates the rights of a secured creditor under a security agreement (for a rule of interpretation with respect to "knowledge", see Introduction, section B, Terminology). This would be the case, for example, if a buyer had knowledge that the sale to it was prohibited by the terms of the security agreement. On the other hand, mere knowledge on the part of the buyer of the fact that the asset was subject to a security right would be insufficient.

77. The "ordinary-course-of-business" approach has the advantage that it is consistent with the commercial expectation that the grantor will sell its inventory of tangible assets (and indeed must do so to remain financially viable), and that buyers of the tangible assets will take them free and clear of existing security rights. Without such an exception to the principle that the security right continues in the asset in the hands of a buyer, a grantor's ability to sell tangible assets in the ordinary course of its business would be greatly hampered, because buyers would have to investigate claims to the tangible assets prior to purchasing them. This situation would result in significant transaction costs and would greatly impede ordinary-course transactions.

78. The ordinary-course-of-business approach also provides a simple and transparent basis for determining whether tangible assets are sold free and clear of security rights. For example, the sale of equipment by an equipment dealer to a manufacturer that will use the equipment in its factory is clearly a sale of inventory in the ordinary course of the dealer's business, and the buyer should automatically take the equipment free and clear of any security rights in favour of the dealer's creditors. This result is in line with the expectations of all parties, and the buyer is certainly entitled to presume that both the seller and any secured creditor of the seller expect the sale to take place in order to generate sales revenue for the seller. Conversely, a sale by the dealer of a large number of machines in bulk to another dealer would presumably not be in the ordinary course of the dealer's business. Similarly, a sale by a printer of old printing presses would also not be in the ordinary course of the printer's business. In most cases, it will be obvious to the buyer, or easy for the buyer to ascertain, that the sale is in the seller's ordinary course of business. For these reasons, the ordinary-course-of-business approach is the approach adopted by the Guide (see recommendation 78, subparagraph (a)).

79. With respect to sales that are obviously outside the ordinary course of the grantor's business, or where there is at least a question in the mind of the buyer, as long as creditors' security rights are subject to registration in a general security

rights registry, the buyer may protect itself by searching the registry to determine whether the asset it is purchasing is subject to a security right and, if so, seek a release of the security right from the secured creditor.

80. In some jurisdictions, buyers of encumbered assets are permitted to take the assets free of the security right, even where the transaction is outside the ordinary course of the seller's business, if the assets are low-cost items. The reason given for this approach is that, in those jurisdictions, the secured transactions law either does not permit registration of a security right in a low-cost item, or the cost of registration is high in relation to the cost of the asset and it would be unfair to impose that cost on a buyer of the item. By contrast, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in setting arbitrary limits, which would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors. For these reasons, the Guide does not adopt an additional exception for low-cost items.

81. More difficult policy choices arise in the relatively uncommon situation where assets are sold several times and no sales are undertaken in the ordinary course of business of the seller. In some States, a purchaser that purchases the assets from a seller that previously purchased the assets from the grantor (a "remote purchaser") obtains the assets free of security rights. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset and, accordingly, have no reason to conduct a search against the previous owner. The problem with this approach is that impairs the reliability of a security right given by a seller because of the possibility that the asset will be sold without the secured creditor's knowledge to a remote purchaser, either innocently or with the specific intention of stripping away the security right. For this reason, other States provide that, where a buyer of tangible assets takes free of a security right granted by its seller, a remote purchaser will also take free of the security right. In these States, if the remote purchaser buys from a seller that purchased the asset subject to the security right, the remote purchaser will acquire the property subject to the security right, unless the remote sale is itself in the ordinary course of the seller's business. To maintain consistency of approach in relation to ordinary-course-of-business sales, the Guide recommends that, where a buyer of tangible assets takes free of a security right granted by its seller, a remote purchaser will also take free of the security right (see recommendation 79). If the seller takes subject to the security right, the remote purchaser will also normally take subject to that right.

82. One potential disadvantage of the ordinary-course-of-business approach, particularly in international trade, arises in those limited situations where it is not clear to a buyer what activities fall within the ordinary course of the seller's business. This said, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved and in these situations the ordinary-course-of-business approach would be consistent with the expectations of the parties. Therefore, the number of cases in which such confusion exists is limited in practice. On balance, the benefits of the ordinary-course-of-business approach outweigh its disadvantages. This approach facilitates commerce

and allows secured creditors and buyers to protect their respective interests in an efficient and cost-effective manner without undermining the promotion of secured credit.

b. The good-faith approach

83. Many States have taken a different approach to determining whether a buyer of encumbered assets takes title to the assets free of a security right created by the seller. In these States, a buyer of tangible assets takes free of any security rights in the tangible assets if the buyer purchases the tangible assets in good faith (without regard to whether the sale was in the ordinary course of business of the seller). States have adopted various formulations of the definition of "good faith" for the purposes of this test. For example, in some States the buyer is under a duty to investigate whether the assets are subject to a security right, while in other States the buyer is not under such a duty.

84. One argument in favour of this approach is that good faith is a notion known to all legal systems and there exists significant experience with its application at both the national and international levels. Another argument is that a presumption should exist that a buyer is acting in good faith unless it is proven otherwise. Yet another argument in favour of this approach is that it relieves the buyer of the cost and time involved in conducting a search of the registry. However, the problem with such an approach is that it focuses on a subjective criterion relating to the knowledge and intentions of the buyer (which also raise difficult evidentiary issues), rather than on the commercial expectations of all parties involved in the transaction.

(iii) Rights of lessees

85. Priority disputes sometimes arise between the holder of a security right in a tangible asset granted by the owner or lessor of the asset and a lessee of such asset. In this context, the issue is not whether the lessee actually takes the asset free of the security right in the sense that the security right is cut off. Rather, the issue is whether the lessee's right to use the leased asset on the terms and conditions set forth in the lease agreement are unaffected by the security right. The key point is whether, once the holder of a security right commences enforcement, the lessee can nevertheless continue using the asset so long as it continues to pay rent and otherwise abides by the terms of the lease. The general principle discussed in relation to buyers applies here as well (see paras. 70-72 above). The asset is, in principle, subject to the security right and thus the secured creditor may enforce its security right upon default of the grantor, even if this means interrupting the use of the asset by the lessee pursuant to the lease.

86. As in the case of buyers of tangible assets subject to a pre-existing security right, many States recognize two exceptions to this general principle. Under either exception, the security right does not cease to exist. However, for the duration of the lease, the right of the secured creditor is limited to the lessor-grantor's own rights in the assets and the lessee may continue to enjoy uninterrupted use of the asset in accordance with the terms of the lease.

87. The first exception is where the secured creditor has authorized the grantor to enter into the lease unaffected by the security right. As in the case of sales of tangible assets, when a secured creditor has authorized the lease, the lessee's

knowledge of the security right is irrelevant. The Guide adopts this exception (see recommendation 77, subparagraph (b)). The second exception relates to situations in which the lessor of the tangible asset is in the business of leasing tangible assets of that type, the lease is entered into in the ordinary course of the lessor's business and the lessee has no actual knowledge that the lease violates the rights of the secured creditor under the security agreement. Such knowledge would exist if, for example, the lessee knew that the security agreement creating such security right specifically prohibited the grantor from leasing the assets. However, the mere knowledge of the existence of the security right, whether arising because the lessee saw a notice registered in the security registration system or in another way, would not be sufficient to defeat the rights of the lessee. This exception is based on similar policy considerations to those relating to the analogous exception for sales of tangible assets in the ordinary course of the seller's business and is the approach adopted in the Guide (see recommendation 78, subparagraph (b), and para. 73 above).

88. An effective secured transactions regime must also address the issue of a sub-lease. In situations in which the rights of a lessee of a tangible asset are deemed to be unaffected by a security right in the assets granted by the lessor, it is generally considered appropriate that the rights of a sub-lessee will also be unaffected. To maintain consistency of approach in relation to ordinary-course-of-business transactions, the Guide recommends that such a rule also apply to sub-leases (see recommendation 79).

(iv) Rights of licensees

89. The same issues discussed above also arise in the context of licensing of intangible assets that are subject to a security right created by the licensor and the general principle applicable to sales and leases of tangible assets also applies to licences of intangible assets (see recommendation 76). Thus, if a security right in an intangible asset is effective against third parties, it will continue in the assets in the hands of the licensee unless one of the exceptions mentioned below applies (see recommendations 77 and 78).

90. The first exception recognized by most States has two branches that track the rule in relation to sales and leases of tangible assets. Analogous to leases, where the secured creditor has authorized the licence, the licensee takes free of the security right and it is irrelevant whether the licensee knew of the security right. The Guide adopts this exception (see recommendation 77, subparagraph (b)).

91. The second exception (also analogous to similar exceptions for sales and leases of tangible assets) is a situation involving a non-exclusive licensing of intangible assets, where the licensor is in the business of granting non-exclusive licences of such assets, the licence is entered into in the ordinary course of the licensor's business, and the licensee had no knowledge that the licence violated the rights of the secured creditor under the security agreement (see recommendation 78, subparagraph (c)). As in the case of sales and leases of tangible assets, it is generally recognized that such knowledge would exist if, for example, the licensee knew that the security agreement creating such security right specifically prohibited the grantor from licensing the assets. However, the mere knowledge of the existence of the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the rights of the licensee.

92. It is important to note that this second exception relates only to non-exclusive licences of intangible assets (e.g. licences under which the licensee is not the sole and exclusive licensee of the intellectual property covered by the licence, as is the case with mass-distributed software programs) and does not apply to exclusive licences. Where a grantor is engaged in the business of licensing intangible assets, a secured creditor holding a security right in the assets normally will expect its grantor to grant non-exclusive licences of the assets in order to generate revenues. Moreover, it is not reasonable to expect the licensee under a non-exclusive licence to search the general security rights registry to ascertain the existence of security rights in the licensed assets. On the other hand, an exclusive licence of intangible assets, under which the licensee is granted the exclusive right to use the assets throughout the world or even in a specific territory, is generally a negotiated transaction. Such a transaction is often out of the ordinary course of the licensor's business (although it also may be in the ordinary course of the licensor's business if the licensor is in the business of negotiating exclusive licences as is often the case, for example, in the motion picture industry). In the case of an exclusive licence, it is reasonable to expect the licensee to search the general security rights registry to determine if the licensed assets are subject to a security right created by the licensor, and to obtain an appropriate waiver or subordination of priority.

93. Finally, as in the case of sales and leases of tangible assets, a secured transactions regime must address the case of sub-licensees. And, as with sales and leases, a strong argument exists in favour of ensuring that a sub-licensee is unaffected by a security right created by the original licensor in those situations where the law deems the licence itself to be unaffected by the security right (see recommendation 79).

(v) Rights of donees and other gratuitous transferees

94. The position of a recipient of an encumbered asset as a gift (i.e. without value; typically a "donee" but also a "legatee") is somewhat different from that of a buyer or other transferee for value. As the gratuitous transferee has not parted with value, there is no objective evidence of detrimental reliance on the grantor's apparently unencumbered ownership. As a result, in a priority dispute between the donee of an asset and the holder of a security right in the asset granted by the transferor, a strong argument exists in favour of awarding priority to the secured creditor, even in circumstances where the security right was not otherwise effective against third parties. A second argument in favour of this approach is that, where an encumbered asset is the subject of a gift, there are no "proceeds" to which the secured creditor may look as substitute encumbered assets. While some States take this approach, most States follow the general rule that only security rights that have been made effective against third parties will have priority over other claimants. This means that a security right that is effective against third parties follows the asset in the hands of a transferee (see recommendation 76) and exceptions are made only for transferees for value, such as buyers, lessees or licensees (see recommendations 77-79). Applying this rule, a donee could never be a transferee in the ordinary course of business and would take free of a security right only if that security right were not effective against third parties.

(d) Priority of preferential claims

95. In many States, as a means of achieving general social goals, certain unsecured claims are re-characterized as preferential claims and given priority, within or even outside insolvency proceedings, over other unsecured claims. In some cases, the priority also extends to secured claims, including secured claims previously registered. For example, in some States the claims of employees for unpaid wages and of the State for unpaid taxes are given priority over previously existing security rights. As social goals differ from jurisdiction to jurisdiction, the precise nature of these claims and the extent to which they are afforded priority are quite variable. Moreover, in many States, at least some of these claims must be registered in order to be effective against third parties, while other States do not require registration for third-party effectiveness.

96. The advantage of establishing these preferential claims is that a social goal may be furthered. The possible disadvantage depends, in large part, on whether the claims are required to be registered. The disadvantage of unregistered preferential claims is that it will typically be difficult or impossible for prospective creditors to know whether such claims exist, a circumstance that increases uncertainty and thereby discourages secured credit. This particular disadvantage does not affect claims that have to be registered. Nonetheless, even registered preferential claims can adversely affect the availability and cost of secured credit. The reason is that, as such claims diminish the economic value of an asset to a secured creditor, creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate or by withholding the estimated amount of such claims from the available credit.

97. To avoid discouraging secured credit, many States have recently cut back on the number of preferential claims that are given priority over existing security rights. The trend in modern legislation is to establish such claims only when there is no other effective means of satisfying the underlying social objective. For example, in some jurisdictions, tax revenue is protected through incentives for company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund. In addition, many States have also sought to limit the impact of preferential claims on the availability of secured credit by imposing a cap either on the amount that may be paid to the preferred claimant or on the percentage of the amount realized upon enforcement that may used to pay them.

98. If preferential claims are permitted to exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims in advance and to protect itself. Some States have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other States have achieved this result by requiring that preferential claims be registered in a public registry and by according priority to such claims only over security rights registered thereafter. When States adopt this second approach, however, much of the rationale for preferential claims disappears. This is because a number of these claims arise immediately prior to insolvency proceedings and therefore there is unlikely to be any secured credit arising after they are registered. The Guide seeks to achieve a balance with respect to preferential claims, not by recommending their registration, but rather by recommending that the law should limit such claims, both in type and amount, and

that, to the extent preferential claims exist, they should be described in the law in a manner that is sufficiently clear and specific, to enable prospective secured creditors to evaluate whether or not to extend credit to a grantor (see recommendation 80).

(e) Priority of rights of judgement creditors

99. In contemporary secured transactions regimes, the general rule is that a security right that is effective against third parties is accorded priority over the rights of an unsecured creditor. However, as discussed in paragraph […] above, in some States the holder of an unsecured claim may obtain a right in the assets of a debtor by obtaining a judgement or provisional court order against the debtor and registering the judgement or provisional court order in the general security rights registry, thereby converting an unsecured claim into a secured claim that ranks according to the ordinary priority rules. Some of these States go further and provide that, where an unsecured creditor has taken the steps required under applicable law to obtain a judgement or provisional court order, the proprietary rights it asserts may actually have priority over certain claims of a pre-existing secured creditor. The law distinguishes these creditors from other unsecured creditors because of their diligence in doing whatever they could do, often at significant cost, to pursue their claim against their obligor. For ease of reference, the term "judgement" is used below to refer to both a judgement and a provisional court order, and the term "judgement creditor" is used to refer to a creditor that has obtained either a judgement or a provisional court order against a debtor.

100. This result is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement but have not taken the time or incurred the expense to do so. However, to avoid giving judgement creditors excessive powers in legal systems where a single creditor may even institute insolvency proceedings, insolvency laws often provide that security rights arising from judgements obtained within a specified period of time prior to the insolvency proceeding may be avoided by the insolvency representative. In various jurisdictions, the judgement creditor's property right is extinguished or not recognized in the debtor's insolvency proceedings.

101. Modern secured transactions regimes typically address this type of priority dispute by balancing the interests of the judgement creditor and the secured creditor. On the one hand, the judgement creditor has an interest in knowing at a given point of time whether there is sufficient value left unencumbered in the grantor's assets for the enforcement of the judgement. On the other hand, a strong policy argument exists in favour of protecting the rights of the secured creditor, on the ground that the secured creditor expressly relied on its security right as a basis for extending credit.

102. Many States seek to achieve this balance by generally giving priority to a security right over a property right of a judgement creditor in encumbered assets, so long as the security right became effective against third parties before the judgement creditor's property right arises. This is the general principle adopted by the Guide (see recommendation 81).

103. In States that seek to protect the rights of judgement creditors, there is typically one exception and two limitations to the general rule. Commonly, an exception to the rights of judgement creditors is created in the case of acquisition

security rights in encumbered assets other than inventory or consumer goods. Priority is accorded to the acquisition security right even if it is not effective at the time the judgement creditor obtains rights in the encumbered assets, so long as the security right is made effective against third parties within the applicable grace period provided for such security rights. A contrary rule would create an unacceptable risk for providers of acquisition financing that had already extended credit prior to the time when the judgement creditor obtained its property right, and thus would discourage acquisition financing (see recommendation 179).

104. The limitations to the rule mentioned above relate to restrictions on the amount of credit given priority. The first limitation arises from the need to protect existing secured creditors from making additional advances based on the value of assets subject to judgement rights. There should be a mechanism to put creditors on notice of the judgement rights. In many jurisdictions in which there is a registration system, this notice is provided by subjecting judgement rights to the registration system. If there is no registration system, or if judgement rights are not subject to the registration system, the judgement creditor might be required to notify the existing secured creditors of the existence of the judgement. In addition, the law may provide that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement right is registered (or after the creditor receives notice of the judgement creditor's right in the encumbered assets), so that the creditor can take steps to protect its rights accordingly. The less time an existing secured creditor has to react to the existence of judgement rights and the less public such judgement rights are made, the more their potential existence will negatively affect the availability and cost of credit in the context of credit transactions that provide for extension of credit at various times after the conclusion of the credit agreement ("future advances").

105. The Guide recommends that secured creditors on record should be notified and that the priority of any security right is limited to credit extended by the secured creditor a certain number of days (e.g. 30-60) after the secured creditor had been notified of the existence of the judgement creditor's right (see recommendation 81, subparagraph (a)). Although this limitation imposes an obligation on the judgement creditor to notify the secured creditor, that obligation is generally not overly burdensome for the judgement creditor and relieves the secured creditor of the obligation to search frequently for judgements against the grantor (which would be a far more burdensome and costly obligation, the cost of which is almost always passed on to the grantor). The existence of the grace period is justified on the ground that it prevents the secured creditor under a revolving loan facility or other credit facility providing for future extensions of credit from having to cut off loans or other credit immediately, a circumstance that could create difficulties for a grantor or even force the grantor into insolvency.

106. The second limitation relates to future advances. The priority of a security right may be extended to advances made even after the secured creditor is notified of the judgement creditor's rights, provided the advance was irrevocably committed, prior to that notice, in a fixed amount or an amount that may be determined pursuant to a specified formula.

107. The rationale for this rule is that it would be unfair to deprive a secured creditor that has irrevocably committed to extend credit of the priority that it relied on when entering into the commitment. The contrary argument is that, under many

credit facilities, the existence of a judgement would constitute an event of default, entitling the secured creditor to cease extending additional credit. However, ceasing to extend credit may not be a sufficient protection for the secured creditor and may be harmful to other parties as well. For example, the sudden loss of credit precipitated by the judgement could well force the grantor into insolvency proceedings, resulting not only in loss to the secured creditor and other creditors but also the possible destruction of the grantor's business. The Guide resolves this priority dispute in favour of the continued extension of credit under an irrevocable credit facility, in the interest of allowing the grantor to remain in business (a circumstance that may result in the greatest chance for the grantor to pay all of its obligations) (see recommendation 81, subparagraph (b)).

(f) Priority of rights of persons providing services with respect to an encumbered asset

108. In many States, creditors that have provided services with respect to, or have added value to, tangible encumbered assets in some way, such as by storing, repairing or transporting them, are given a property right in the assets. In some States, this right can ripen into a fully formed security right that permits the service provider to enforce its claim as if it were a security right. In other States, this right is simply a right to refuse to hand over the assets to anyone seeking their delivery. Regardless of the nature of the service provider's right, in these States it may only be claimed while the assets are still in the possession of the service provider.

109. This treatment of service providers has the advantage of inducing them to continue providing services and of facilitating the maintenance and preservation of encumbered assets. In most States the right given to service providers has priority over all other rights that may be claimed in assets in their possession. In particular, this right ranks ahead of any other security right in those assets, regardless of the respective dates on which the two rights became effective against third parties. The rationale underlying this priority rule is that service providers are not professional financiers and should be relieved of searching the registry to determine the existence of competing security rights before providing services. Moreover, the rule facilitates services such as storage and repairs and other improvements that typically benefit secured creditors as well as grantors.

110. A question arises as to whether the priority given to service providers should be limited in amount or recognized only in certain circumstances. One approach is to limit priority to an amount (such as one month's rent in the case of landlords) and to recognize their priority over pre-existing security rights only where value is added which directly benefits the holders of the pre-existing security rights. This approach would have the advantage that the rights of secured creditors would not be unduly limited. It would have the disadvantage, though, that service providers that did not add value would not be protected. In addition, the amount of the value added by the service providers would need to be determined, a requirement that may add costs and create litigation.

111. Another approach is to limit the priority of service providers to the reasonable value of services provided. Such an approach would reflect a fair and efficient balance between the conflicting interests. It would ensure reasonable protection of service providers, while avoiding difficult questions of proof as to the relative value of the encumbered assets before and after the services are rendered. As the

reasonable value of services is based on a calculation that can be verified comparatively and publicly, this approach also minimizes the costs associated with claiming the right. For this reason, it is the approach recommended in the Guide (see recommendation 82).

(g) Priority of a supplier's reclamation right

112. In some States, a supplier selling tangible assets on unsecured credit may, upon default or financial insolvency of the buyer (which may or may not be accompanied by the grantor's insolvency proceedings), be given by law a right to reclaim the tangible assets from the buyer within a specified period of time, which is known as the "reclamation period". If insolvency proceedings have commenced with respect to the buyer, applicable insolvency law will determine the extent to which the rights of reclamation claimants would be stayed or otherwise affected (see recommendations 39-51 of the *UNCITRAL Insolvency Guide*).

113. An important question is whether a reclamation claim relating to specific tangible assets should have priority over a pre-existing security right in the same assets, either outside or inside the insolvency context. In other words the question is whether, if the assets of the buyer (including the assets sought to be reclaimed) are subject to a security right, the reclaimed assets should be returned to the seller free of such security right. In some States, the reclamation has a retroactive effect, placing the seller in the same position as it was prior to the sale (i.e. holding assets that were not subject to any security rights in favour of the buyer's creditors). However, in other States, the assets remain subject to the pre-existing security rights, provided that the security right has become effective against third parties before the supplier exercises its reclamation right. The rationale for this approach is that the holders of such security rights would likely have relied on the existence of the assets being reclaimed when extending credit. Also, if the reclamation rights were given priority in this situation, the response of inventory acquisition financiers often will be to reduce the amount of credit extended to the grantor by "reserving" for potential reclamation claims.

114. Where States have enacted a modern secured transaction regime of the type envisioned in the Guide, the seller is able to protect itself by obtaining an acquisition security right in the assets, and therefore the policy sought to be promoted by providing for reclamation rights can usually be achieved by other means. The Guide, consequently, recommends that reclamation rights do not have priority unless they are exercised before a competing security right has become effective against third parties (see recommendation 83).

(h) Priority of a security right in an attachment

115. Tangible assets may often become attachments to other tangible assets (whether movable, as in the case of tyres attached to road vehicles, or immovable, as in the case of ornamental fireplaces or chandeliers or furnaces attached to buildings). In these cases, there can often be conflicts between security rights created in the attachment and security rights created in the object to which the attachment is affixed. Different policy considerations come into play when determining how to determine the relative priority of these rights as between attachments to immovable property and attachments to movable assets.

(i) Priority of a security right in an attachment to immovable property

116. To the extent that a secured transactions regime permits security rights to be created in attachments to immovable property (as recommended by the Guide; see recommendation 21), it must also include rules governing the relative priority of a holder of security rights in an attachment to immovable property vis-à-vis persons that hold rights with respect to the related immovable property. A paramount consideration of such priority rules is to avoid unnecessarily disturbing well-established principles of immovable property law.

117. Such priority rules will have to address a number of different priority conflicts. The first is a conflict between a security right in an attachment (or any other right in an attachment, such as the right of a buyer or a lessee), that is created and made effective against third parties under immovable property law and a security right in the attachment that is made effective against third parties under the secured transactions regime governing movable assets. In this situation, out of deference to immovable property law, most States give priority to the right created and made effective against third parties under immovable property law. With a view to preserving the reliability of the immovable property registry, this is also the position taken in the Guide (see recommendation 84).

118. A second type of priority conflict may arise between a security right in an encumbered asset that is either an attachment to immovable property at the time the security right becomes effective against third parties or that becomes an attachment to immovable property subsequently, where the security right has been made effective against third parties by registration in the immovable property registry, and a security right (or other right, such as the right of a buyer or lessor) in the related immovable property. In these cases, priority will be determined according to the order of registration in the immovable property registry. Once again, the rationale is to preserve the reliability of the immovable property registry, a rationale that also underlies the position taken in the Guide (see recommendation 85).

119. A third type of priority conflict may arise between an acquisition security right in an encumbered asset that becomes an attachment to immovable property and an encumbrance in the immovable property. In order to promote the financing of the acquisition of attachments, the Guide recommends that priority be given to the acquisition security right in the encumbered asset that becomes an attachment (see recommendation 180; under recommendation 192, the same principle will also apply in cases where the acquisition financier in the non-unitary regime has a retention-of-title right or a financial lease right).

(ii) Priority of a security right in an attachment to a movable asset

120. Several types of priority conflict may arise with respect to security rights in assets that later became attachments to movable assets. One such type may arise between two security rights in assets that later became attachments to one or more movable asset. Another priority conflict may arise between a security right in an asset that later became an attachment to a movable asset and a security right in the relevant movable asset to which the attachment was attached where both have been registered in the general security rights registry. In these cases, priority may be determined in accordance with the order of registration or third-party effectiveness (see recommendation 173). A third type of priority conflict may arise between a

security right in an asset that later became an attachment where that security right was made effective against third parties by registration in a specialized registry or notation on a title certificate and a security right in the related movable asset that was registered in the general security rights registry. In this case, priority is given to the former right in deference to the policy in favour of preserving the integrity of specialized registries and title-notation systems (see recommendation 74, subparagraph (a)). A fourth type of priority conflict may arise between two security rights in assets that later became attachments to one or more movable assets where both rights have been made effective against third parties by registration in a specialized registry or notation on a title certificate. A fifth priority conflict may arise between a security right in an asset that later became an attachment and a security right in the relevant movable asset to which the attachment was attached where both rights have been made effective against third parties by registration in a specialized registry or notation on a title certificate. In these cases, priority is determined according to the time of such registration or notation (see recommendations 74, subparagraph (b), and 86).

(i) Priority of a security right in a mass or product derived from a security right in processed or commingled assets

121. Many types of tangible asset are destined to be manufactured, transformed or commingled with other tangible assets of the same kind. This circumstance gives rise to three types of potential priority contest that require special rules. These three types are: (a) contests between security rights taken in the same items of tangible assets that ultimately become commingled in a mass or product (e.g. sugar and sugar; oil and oil; grain and grain); (b) contests involving security rights in different tangible assets that ultimately become part of a mass or product (e.g. sugar and flour, fibreglass and polyester resin, cloth and dye in fabrics); and (c) contests involving a security right originally taken in separate tangible assets and a security right in the mass or product (e.g. sugar and cake, fibreglass and furniture, cloth and trousers). Each of these potential contests is discussed below.

(i) Priority of security rights in the same tangible assets that are commingled in a mass or product

122. States typically provide that non-possessory security rights in the same tangible assets that become commingled continue into the mass or product and have the same priority as against each other as they had prior to the commingling. The rationale for this rule is that the commingling of tangible assets into a mass or product should have no bearing on the respective rights of creditors with competing security rights in the separate tangible assets. As between each other, they should be in an identical position. Of course, in these cases the total amount available to satisfy the claims of these secured creditors cannot exceed the value of the tangible assets encumbered by these competing security rights immediately before they became commingled in the mass or product (see recommendation 22). The Guide recommends this principle as well (see recommendation 87).

(ii) Priority of security rights in tangible assets that become part of a mass or product

123. If security rights in different tangible assets that ultimately become part of a mass or product continue in the mass or product, the issue is how to determine the

relative value of the rights that may be claimed by each creditor. States have taken many approaches to deciding this question, depending on how they decide the extent of the secured creditor's rights in the mass or product. The Guide recommends that secured creditors should be entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of the assets encumbered by their respective security rights immediately prior to manufacture or incorporation to the value of all the components at that time (see recommendation 22). Using the example of the cake, if the value of the sugar is 2 and the flour 5, while the value of the cake when baked is 8, the creditors will receive 2 and 5, respectively, but neither secured creditor will receive more than the amount of its secured obligation. Conversely, if the value of the sugar is 2 and the flour 5, while the value of the cake when baked is 6, the creditors will receive two-sevenths and five-sevenths of 6, respectively. Each creditor in this situation will suffer a proportional decrease.

124. It follows that in these types of case, each creditor is entitled to claim its pre-manufacture priority in the share of the final product that represents the value of the component part over which it had taken security. This means that, if the secured claim of one secured creditor is less than the value of its component part and the secured claim of another secured creditor is greater than the value of its component, the second secured creditor cannot claim a priority right in the excess value attributable to the share of the first secured creditor. To avoid these limitations, many secured creditors draft security agreements that describe the encumbered assets as including not only the component parts, but also any mass or product that is manufactured from these component parts. However, States typically follow the relative valuation formula described above for determining rights of secured creditors with security rights in different components of a mass or product, and this is also the approach recommended in the Guide (see recommendation 88).

(iii) Priority of a security right originally taken in tangible assets as against a security right in the mass or product

125. The third type of competition that States must resolve is that between security rights in tangible assets that become part of a mass or product and security rights taken in the mass or product itself. Generally, States take the position that the regular priority rules apply to govern these conflicts. For example, if Secured Creditor A has a security right in sugar that is the subject of a notice registered on 1 January, and Secured Creditor B has a security right in present and future cakes that is the subject of a notice registered on 1 February, Secured Creditor A will have priority, subject to the limitation, set out in recommendation 22, that its security right is limited to the value of the assets immediately before they became part of the mass or product. Conversely, if Secured Creditor A has a security right in sugar that is the subject of a notice registered on 1 February, and Secured Creditor B has a security right in present and future cakes that is the subject of a notice registered on 1 January, Secured Creditor B will have priority.

126. There is, however, one exception to this principle, which arises where the secured creditor that takes security in a component part is an acquisition financier (see chapter XI on acquisition financing). In these cases, and in keeping with the general treatment of acquisition financiers, States usually give the acquisition security right priority over all security rights in the mass or product that extend to

future assets. To maintain a consistent regime promoting the availability of credit for the acquisition of tangible assets, the Guide also recommends adoption of this principle (see recommendation 89).

5. Scope and interpretation of priority rules

(a) Irrelevance of knowledge of the existence of the security right

127. One of the key features of a modern secured transactions regime is that, regardless of the basis adopted for determining priority, it will be fixed by reference to objective facts (e.g. registration of a notice, possession, a control agreement, or a notation on a title certificate). For such a priority system to provide certainty, these objective facts must be the exclusive means for determining priority. This is why in most States that have modernized their regime of security rights the ordering of priority as established by, for example, the date of registration of a notice or creditor possession applies even if a subsequent creditor or other competing claimant acquired its rights with knowledge of an existing security right that was not then registered or otherwise effective against third parties.

128. The rationale for this rule is based on the premise that it is often difficult to prove that a person had knowledge of a particular fact at a particular time. This is especially true in the case of a corporation or other legal entity with numerous employees. Priority rules that are dependent on subjective knowledge provide opportunities to complicate dispute resolution, thereby diminishing certainty as to the priority status of secured creditors and reducing the efficiency and effectiveness of the system. While it might seem odd to give priority to a creditor that knows of a security right already created by a grantor, basing priority on the order of a publicly verifiable event through which a creditor makes its rights effective against third parties ensures certainty in the relationships between potentially competing claimants. This consideration supports the recommendation in the Guide that mere knowledge of a security right is irrelevant to the determination of priority (see recommendation 90).

129. This said, it is important to distinguish knowledge merely of the existence of a security right from knowledge that a particular transaction violates the rights of a secured creditor. For example, knowledge by a buyer of an unregistered security right will not disrupt the priority regime established for registered rights. By contrast, should the buyer know as well that the asset it acquires is being sold in contravention of the specific terms of a security agreement (e.g. a prohibition on the grantor's right to sell encumbered assets) significant legal ramifications may well follow (e.g. acquiring title to the asset subject to existing security rights; see paras. 70-72 above; see also recommendations 78, 98, subparagraph (b), 102 and 103).

(b) Freedom of contract with respect to priority: subordination

130. The priority regime in most States establishes rules that apply unless they are specifically modified by affected parties. In other words, most States provide that a secured creditor may at any time, whether unilaterally or by agreement, subordinate its security right to the right of an existing or future competing claimant. For example, Lender A, holding a first-priority security right in all existing and after-acquired assets of a grantor, may agree to permit the grantor to give a

first-priority security right in a particular asset (e.g. a piece of equipment) to Lender B so that the grantor could obtain additional financing from Lender B based on the value of that asset. The recognition of the validity of subordination of security rights reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention). Consistent with the widespread recognition of the utility of subordination agreements, the Guide recommends that they be permitted (see recommendation 91).

131. However, subordination cannot affect the rights of a competing claimant without its consent. Thus, a subordination agreement cannot adversely affect the priority of a secured creditor that is not a party to that agreement. This means that, in those States which require creditors to indicate in the registered notice the maximum amount for which a security right is granted (see recommendation 57, subparagraph (d)), the subordination will be limited to the indicated value of the higher ranking right. So, for example, if Lender A has limited its security right to 100,000 and Lender B has security for 50,000, a subordination agreement between Lender A and Lender C that has security for 200,000 cannot operate so as to permit Lender C to claim more than 100,000 by priority over Lender B.

132. The purpose of a subordination agreement is to permit secured creditors to agree among themselves as to the most efficient allocation of priority of their rights in encumbered assets. To obtain the full benefit of these consensual allocations, it is essential that the priority afforded by a subordination agreement continue to apply in insolvency proceedings of the grantor. In some jurisdictions, such a provision already exists in the insolvency regime. In others it may be necessary to amend insolvency laws so as to empower the courts to enforce a subordination agreement and to enable insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see chapter XVI on the impact of insolvency on a security right, para. 63, and recommendation 237).

133. Subordination of security rights and other proprietary rights in encumbered assets does not mean subordination of payments prior to default. This is a matter for the general law of obligations. Normally, prior to default, and as long as the grantor continues to repay the loan or other credit received, the secured creditor is not entitled to enforce its security right and priority is not an issue. That is, as long as no fraud is being committed and in the absence of an agreement to the contrary between a grantor and a secured creditor, a grantor is not precluded from making payments on obligations secured by subordinate security rights.

(c) Impact of continuity of third-party effectiveness on priority

134. Where the third-party effectiveness of a security right may be achieved by more than one method (e.g. automatically, by registration, by possession, by control or by notation on a title certificate), a question arises as to whether a secured creditor that initially established the priority of its security right by reference to one such method should be permitted to change to another method without losing its original priority. Some States do not permit creditors to change the means by which they have achieved third-party effectiveness. As a result, in these States, it is not possible for a creditor's priority to be maintained following such a change. For example, if a creditor registers a notice in the general security rights register on Day 1, on Day 10 obtains possession of the encumbered asset and on Day 20 cancels the registration, from that time onwards the relevant time for establishing

priority in these States would be Day 10, and not Day 1. If the initial method of establishing priority no longer exists, priority can only date from the time when a still-existing method for establishing priority was achieved.

135. In other States, it is possible to maintain priority even after a change in the method by which third-party effectiveness is achieved. Whether priority is maintained depends on the manner in which the different methods for achieving third-party effectiveness are integrated. In these States, the principle is that a security right will not lose its priority as long as there is no time during which the security right is not effective against third parties. For example, if a security right in an asset first becomes effective by possession and the secured creditor subsequently registers a notice of the security right in the general security rights registry and returns possession to the grantor, the security right remains effective as against third parties and priority relates back to the time that possession was initially obtained as long as the registration precedes the creditor's surrender of possession. If, however, the secured creditor registers the notice after it surrenders possession of the asset, the priority of the security right dates only from the time that the secured creditor registers the notice. Rules providing for continuity in priority are especially important in cases where effectiveness against third parties was first established through possession and the duration of the credit extends past the point where the grantor requires the use of the encumbered asset. Consistent with its recommendations relating to continuity of third-party effectiveness (see recommendations 46 and 47), the Guide takes the position that, for the purpose of applying the temporal priority rules recommended in the Guide, priority should be maintained notwithstanding a change in the method by which it is determined (see recommendations 92 and 93).

136. It should be noted that the above-mentioned rule applies only where the temporal priority rules are applied to determine priority, and does not apply where the non-temporal rules are applied. In the latter case, a change in the mode of third-party effectiveness will affect the priority of a security right, even if third-party effectiveness is continuous. For example, if the holder of a negotiable instrument registers a notice of a security right in the instrument prior to surrendering possession, the special priority attaching to possession of the instrument will not be maintained simply through the registration. Should a second secured creditor have registered a notice before the secured creditor surrendering possession registered its notice, the second secured creditor will take priority based on its prior registration (see paras. 155-157 below; see also recommendation 98). Similarly, if a secured creditor with control with respect to a right to payment of funds credited to a bank account registers a notice of its security right and then surrenders control, the special priority attaching to control is lost. Should another secured creditor have registered a notice in the general security rights registry before the initial taking of control, once control is surrendered, that secured creditor would have priority based on its prior registration (see paras. 158-164 below; see also recommendation 100).

(d) Extent of priority: future advances, and future and contingent obligations

137. Previous chapters have addressed the fact that, in modern secured transactions regimes, a security right can secure not only obligations existing at the time the security right is created, but also future and contingent obligations as well

(see chapter IV on the creation of a security right, paras. […]; see also recommendation 16). Most States provide that the initial security right covers principal and interest as stipulated in the agreement as well as any fees and costs associated with recovery of payment.

138. As for future advances under existing credit arrangements and contingent obligations, States take different positions. Some give the same priority to future advances as to the original extension of credit, but in order for the initial priority to extend to future and contingent obligations, these States require such obligations to be determinable both as to type and amount (e.g. the agreement specifies that only future advances under a line of credit up to a maximum exposure of 100,000 be secured). In other States, a security right may extend to all monetary and non-monetary obligations owed to the secured creditor of whatever type and in whatever amount, as long as the agreement so specifies. In these States, future and contingent obligations under the security agreement will have the same priority as the initial extension of credit.

139. The practical consequence is that a secured creditor is assured, at the time it makes a commitment to extend credit, that the priority of its security right will extend, not only to the credit it extends contemporaneously with the conclusion of the security agreement, but also to: (a) obligations that arise thereafter pursuant to the terms of the security agreement (such as future advances under a revolving credit agreement); and (b) contingent obligations that become actual obligations upon the occurrence of the contingency (such as obligations that become payable to the secured party under a guarantee). For example, in the case of a revolving credit facility under which the lender has agreed on Day 1 to make advances to the grantor from time to time for the entire one-year term of the facility secured by a security right in the grantor's assets, the security right will have the same priority for all of the advances made, regardless of whether they are made on Day 1, 35 or 265.

140. In the case of credit extended to enable a grantor to purchase tangible assets or services in instalments over time, this approach results in the entire claim being treated as coming into existence at the time when the contract for the purchase of the tangible assets or services is concluded, and not at the time of each delivery of tangible assets or rendering of services. One rationale for this approach is that it is the most cost-efficient approach, because it relieves the secured creditor of the need to determine priority each time it extends credit, a determination that typically involves additional searches for new registrations by other creditors, the execution of additional agreements and additional registrations for amounts of credit extended subsequent to the time the security right was created. Because the costs associated with these additional steps invariably are passed on to the grantor directly or reflected in an increase in the interest rate, eliminating them can reduce the cost of credit for the grantor. Another rationale for this approach is that it minimizes the risk to the grantor that subsequent extensions of credit under the security agreement will be interrupted if the secured creditor determines that a future advance does not have the same priority as the initial advances. For these reasons the Guide recommends adoption of priority rules that extend priority to future obligations (see recommendation 94).

141. The foregoing priority rules are, nonetheless, subject to two possible limitations. First, as noted, in some States where the priority of a security right extends to future extensions of credit, priority is limited to the maximum amount

specified in the notice registered in a public registry with respect to the security right. The rationale for this approach is that it may encourage subordinate financing by encouraging prospective subordinate creditors to extend credit on the residual value of the encumbered assets (e.g. the value of the encumbered assets in excess of the maximum amount secured by the higher-ranking security right referred to in the registered notice) to the extent the prospective creditor is able to satisfy itself that a sufficient residual value exists (see recommendation 95). Other States do not take this approach on the basis that it might encourage secured creditors to inflate the amount mentioned in the registered notice to include an amount greater than that contemplated at the time of the security agreement to accommodate possible unanticipated future advances (see chapter VI on the registry system, paras. […]; see also recommendation 57, subparagraph (d)).

142. Second, the Guide recognizes that, in some circumstances, a secured creditor should not be able to assert its priority with respect to future advances against a creditor that obtains a judgement or provisional court order against the grantor and takes steps to enforce the judgement against the encumbered assets (see paras. 99-107 above; see also recommendations 81 and 94).

(e) Application of priority rules to a security right in after-acquired assets

143. As discussed in greater detail in chapter IV on the creation of a security right, in some States a security right may be created in assets that the grantor may acquire in the future ("after-acquired assets"). In these States, assuming that the description of the after-acquired assets is sufficient to identify them, a security right in these assets is obtained automatically at the time the grantor acquires them, without any additional steps being required at the time of acquisition. As a result, the costs incidental to the creation of the security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory that is continuously being acquired for resale, receivables that are continuously being collected and regenerated (see chapter II on the scope of application and other general rules, section F, Examples of financing practices covered, paras. […]) and equipment that is periodically being replaced in the normal operation of the grantor's business.

144. The recognition of the automatic creation of a security right in after-acquired assets raises the question as to whether priority should date from the time when the security right is first registered or becomes effective against third parties, or from the time the grantor acquires the assets. Different States address this matter in different ways. Some States adopt an approach that differentiates according to the nature of the creditor competing for priority. In these States, priority dates, as against other consensual secured creditors, from the date of registration or third-party effectiveness and, as against all other competing claimants, from the date the asset is acquired by the grantor. In other States, priority for all after-acquired assets, and as against all competing claimants, is determined by reference to the date priority was initially established.

145. It is generally accepted that the second of these approaches is more efficient and effective in promoting the availability of secured credit. Thus, modern secured transactions regimes typically specify that, in such cases, the priority of a security right extends to all encumbered assets covered by the registered notice, regardless

of whether they come into existence before, at or after the time of registration. This is the approach taken by the Guide (see recommendation 96).

(f) Application of priority rules to a security right in proceeds

146. If a creditor has a security right in proceeds (for the definition of "proceeds", see Introduction, section B, Terminology), issues will arise as to the priority of that security right as against the rights of competing claimants. Competing claimants with respect to proceeds may include, among others, another creditor of the grantor that has a security right in the proceeds and a creditor of the grantor that has obtained a right by judgement against the proceeds.

147. Assets that constitute proceeds to one secured creditor may constitute original encumbered assets to another secured creditor. For example, Creditor A may have a security right in all of the grantor's receivables by virtue of its security right in all of the grantor's existing and future inventory and the proceeds arising upon the sale or other disposition thereof; Creditor B may have a security right in all of the grantor's existing and future receivables as original encumbered assets. If the grantor later sells on credit inventory that is subject to the security right of Creditor A, both creditors have a security right in the receivables generated by the sale: Creditor A has a security right in the receivables as proceeds of the encumbered inventory, and Creditor B has a security right in the receivables as original encumbered assets.

148. The approach to priority taken in States that recognize a security right in proceeds will often differ depending on the nature of the competing claimants and the type of asset that gives rise to the proceeds. In priority disputes between holders of competing security rights, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to rights in the original encumbered assets. Thus, the time of third-party effectiveness or the time of registration of a notice in the general security rights registry of a security right in an encumbered asset would also be the time of third-party effectiveness or registration, respectively, of a security right in the proceeds of such encumbered asset.

149. In the case of competitions between secured creditors with security rights in assets as proceeds and secured creditors with rights in these assets as original encumbered assets, some States distinguish between proceeds in the form of receivables and proceeds in the form of tangible assets (for example, tangible assets obtained in exchange). These States also typically distinguish between proceeds arising from the sale of inventory and proceeds arising from the sale of equipment. The general rule is that a secured creditor that takes security in receivables generated by the sale of inventory as original encumbered assets will have priority over a creditor claiming such receivables as proceeds, regardless of the respective dates on which their rights became effective as against third parties.

150. In other States, no distinctions as to the form of proceeds or the nature of the assets are made. The rule is that the first right in particular assets that is reflected in a registration has priority over the rights of a competing claimant. For example, if the registration of the security right in assets, the sale of which generates the proceeds, predates the registration of the security right in the proceeds as original encumbered assets, the security right in the assets giving rise to the proceeds has priority. Conversely, if a notice was registered with respect to the right in the

proceeds as original encumbered assets before the competing claimant made a registration with respect to the assets giving rise to the proceeds, the security right of the creditor in the proceeds as original encumbered assets would have priority. This is the approach recommended in the Guide (see recommendation 97).

151. In cases in which the order of priority of competing rights in the originally encumbered asset is not determined by the order of registration in the general security rights registry (as is the case, for example, with acquisition financing rights that enjoy a special priority position), a separate determination will be necessary for the priority rule that would apply to proceeds (see chapter XI on acquisition financing, paras. […]; see also recommendations 181 and 182 (unitary approach) and 194-196 (non-unitary approach)).

B. Asset-specific remarks

152. The particular priority conflicts that generally recur in connection with tangible assets have been reviewed above. The "first-in-time" principle is an efficient starting point for establishing priorities.

153. As noted, however, the principle requires adjustment in certain cases. Some adjustments involve other secured creditors (e.g. security rights in attachments or security rights in masses or products). Other adjustments involve competing claimants that are not secured creditors (e.g. transferees, lessees and licenses or insolvency representatives).

154. In addition to these adjustments resulting from the diversity of obligations being secured and the diversity of competing claimants, modern secured transactions regimes also contain a number of special priority rules that apply to particular types of asset and flow from the particular means for achieving third-party effectiveness applicable to these types of asset. This section deals with priority issues relating to such types of asset.

1. Priority of a security right in a negotiable instrument

155. Many States have adopted special priority rules for security rights in negotiable instruments, such as cheques, bills of exchange and promissory notes. These rules are a reflection of the importance of the concept of negotiability in those States.

156. As discussed (see chapter V on the effectiveness of a security right against third parties), in many States, security rights in negotiable instruments may be made effective either by registration of the security right in the general security rights registry or by transfer of possession of the instrument (see recommendation 37). In these States, priority is often accorded to a security right made effective against third parties by transfer of possession of the instrument over a security right made effective against third parties by registration, regardless of when registration occurs. The rationale for this rule is that it resolves the priority conflict in favour of preserving the unfettered negotiability of negotiable instruments. To preserve the coherence of existing law governing negotiable instruments (for a rule of interpretation with respect to the expression "law governing negotiable

instruments", see Introduction, section B, Terminology), the Guide recommends adopting this priority principle (see recommendation 98).

157. For the same reason, in these States, priority is often accorded to a buyer or other transferee (in a consensual transaction), if that person qualifies as a protected holder of the instrument under the law governing negotiable instruments. A like priority is also given if the buyer or other transferee takes possession of the instrument and gives value in good faith and without knowledge that the transfer is in violation of the secured creditor's rights. It should be noted in this regard that knowledge of the existence of a security right on the part of a transferee of an instrument or a document does not mean, by itself, that the transferee did not act in good faith. The buyer must know that the transfer free of the security right is prohibited under the security agreement. Here also, the Guide adopts a priority rule that follows the above principles of negotiable instruments law (see recommendation 99).

2. Priority of a security right in a right to payment of funds credited to a bank account

158. A comprehensive priority regime typically addresses a number of different priority conflicts relating to security rights in rights to payment of funds credited to a bank account (for a definition of "bank account", see Introduction, section B, Terminology). Some States consider the right to payment of funds credited to a bank account simply to be a receivable. In these States, no special rules govern the creation or the third-party effectiveness of security rights in the right to payment. In other States, third-party effectiveness may also be achieved by control. In these cases, States must also determine the priority consequences of achieving third-party effectiveness by such a method (see paras. 39 and 40 above). Several different priority conflicts are possible.

159. One type of priority conflict is between a security right made effective against third parties by control and a security right made effective against third parties by a method other than control. In this situation, States that have adopted the concept of control accord priority to the security right made effective against third parties by control. The reason is that that outcome facilitates financial transactions that rely on rights to payment of funds credited to a bank account, relieving secured creditors from the necessity of searching the general security rights registry. This is also the position taken in the Guide (see recommendation 100, first sentence).

160. A second type of priority conflict is that between two security rights, each of which is made effective by control. Here, the logical outcome, usually adopted in States that recognize control agreements, is to accord priority to the security right that was first made effective by control (i.e. in the order in which the respective control agreements were concluded). This conflict will not arise often in practice, because it is unlikely that a depositary bank will knowingly enter into more than one control agreement with respect to the same bank account in the absence of an agreement between both secured creditors as to how priority will be determined. Nonetheless, the conflict is theoretically possible, and the Guide therefore takes the position that the normal "first-in-time" priority principle should apply in these cases (see recommendation 100, second sentence).

161. Yet another type of priority conflict is where one of the secured creditors is the depositary bank itself. In this situation, a strong argument exists in favour of according priority to the depositary bank. As the depositary bank generally will win in such a situation by reason of the right of set-off that it generally enjoys under non-secured transactions law (unless it has expressly waived its right), a priority rule that favours the bank in this circumstance allows the conflict to be resolved within the confines of the priority regime without resorting to other law. Adoption of such a principle is recommended in the Guide (see recommendation 100, third sentence).

162. States that adopt the special priority rule just noted often make an exception for the circumstance in which the priority conflict is between the depositary bank and a secured creditor that obtains control of the bank account by becoming the customer of the depositary bank. In such cases, they generally take the position that priority should be given to the customer. The rationale for this approach is that, by accepting the competing secured creditor as its customer, the depository bank generally releases its claim in the deposit agreement that it enters into with its customer. Also, the depositary bank would often lose its right of set-off in this situation; since the bank account is not in the grantor's name, there would be no mutuality between the depository bank and the grantor and hence, no right of set-off (see recommendation 100, third sentence).

163. A fourth type of conflict is one between a security right in a right to payment of funds credited to a bank account and any rights of set-off the depositary bank might have against the grantor-client. To avoid undermining the bank-client relationship, the law of set-off generally gives priority to the depositary bank's rights of set-off. In some States, this concept of priority has been explicitly incorporated into the secured transactions law. This is also the position that is recommended in the Guide (see recommendation 101).

164. A fifth type of priority conflict can arise between a security right in a right to payment of funds credited to a bank account and the rights of a transferee of funds from that bank account, where the transfer is initiated by the grantor. The term "transfer of funds" is intended to cover a variety of transfers, including by cheque and electronic means. In these situations, a strong policy argument in favour of the free negotiability of funds supports a rule that accords priority to the transferee, so long as the transferee was not aware that the transfer of funds to it was in violation of the rights of a secured creditor under its security agreement. If, on the other hand, the transferee knew that the transfer violated the security agreement, it would take the funds subject to the security right. This is the recommendation adopted in the Guide, subject to the caveat that the recommendation is not intended adversely to affect the rights of transferees of funds from bank accounts under law other than the secured transactions law (see recommendation 102).

3. Priority of a security right in money

165. In the interest of maximizing the negotiability of money, many States permit a transferee of money to take the money free of the claims of other persons, including the holders of security rights in the money (for the definition of "money", see Introduction, section B, Terminology). As in the case of transferees of funds from a bank account, the only exception to this priority rule is if the transferee has knowledge that the transfer of the money is in violation of the security agreement

between the account holder and the secured party (e.g. if the transferee has colluded with the holder of the bank account to deprive the secured creditor of its rights). As in similar situations involving the transfer of funds from bank accounts, mere knowledge of the existence of the security right would not defeat the rights of the transferee. Here also, in keeping with generally accepted practice governing money, the Guide recommends adoption of this priority principle (see recommendation 103).

4. Priority of a security right in a right to receive the proceeds under an independent undertaking

166. The law governing independent undertakings has developed largely through practices in the letter-of-credit and bank-guarantee industry. As already mentioned (see chapter V on the effectiveness of a security right against third parties), a security right in a right to receive the proceeds under an independent undertaking is made effective against third parties only by control. As the typical method of achieving control in this context is by obtaining an acknowledgment, in the case of several potential payers (e.g. the guarantor/issuer, confirmer and several nominated persons), control may be achieved only as against each particular guarantor/issuer, confirmer or nominated person that gave an acknowledgment. Thus, the priority rule normally focuses on the particular person that is the payer.

167. Normally, in the rare case of a priority contest between the holder of a security right in a right to receive the proceeds under an independent undertaking that has been made effective by control and a security right made effective against third parties by reason of the fact that it secures payment of a receivable, negotiable instrument or other intangible asset, the former will prevail (see recommendations 48 and 104). As in the case of bank accounts, this rule is based on the need to facilitate transactions involving independent undertakings by relieving parties of the necessity of searching the general security rights registry to determine whether the receivable supported by the independent undertaking is also subject to a security right, thereby encouraging reliance on independent undertakings. As a practical matter, this particular type of priority conflict is quite rare, because in most cases the beneficiary of the receivable will also be the beneficiary of the independent undertaking. In any case, consistent with the general “first-in-time” principle, as between two security rights made effective against third parties by control through acknowledgement, priority is accorded to the first security right to be acknowledged by the payer. The rationale for this result is largely practice-based, in that it is a special rule required in order to keep low the cost of independent undertakings. As independent undertakings constitute a highly specialized branch of commercial law that has been largely developed by practice, the Guide recommends that relevant priority rules be consistent with these principles (see recommendation 104).

5. Priority of a security right in a negotiable document or tangible assets covered by a negotiable document

168. Modern secured transactions regimes typically have rules that address at least two priority conflicts involving negotiable documents, such as negotiable warehouse receipts and bills of lading. The first is a conflict between the holder of a security right in a negotiable document or the tangible assets covered thereby, on the one

hand, and a person to whom the document has been duly negotiated, on the other. In the interest of preserving negotiability under non-secured transactions law, most States provide that the security right in the negotiable document and the tangible assets covered thereby will be subordinate to any superior rights acquired by the transferee of the document under the law governing negotiable documents. For the same reason, this is the position recommended in the Guide (see recommendation 105).

169. The second type of conflict is between the holder of a security right in the tangible assets covered by the negotiable document that is derived from a security right in the negotiable document and the holder of a security right in the tangible assets resulting from some other transaction (e.g. the creation of a direct security right in the tangible assets). This type of conflict can arise either where the direct security right in the tangible assets became effective against third parties while the tangible assets were subject to the negotiable document or where the direct security right in the tangible assets became effective against third parties before the tangible assets became subject to the negotiable document. In either situation, priority is usually given to the security right in the negotiable document. Such a priority rule encourages reliance on negotiable documents as a medium of commerce, especially in connection with bills of lading issued in connection with international sales. It is, therefore, the position taken in the Guide (see recommendation 106).

170. However, an exception to this rule is warranted in the particular situation where the tangible asset subject to the negotiable document is an asset other than inventory. Creditors normally expect that inventory will be shipped and a bill of lading or warehouse receipt issued, and therefore can anticipate a short period where assets that their security right directly encumbers will be covered by a bill or receipt. This is not usually the case with, for example, equipment. Hence, the rule giving absolute priority to security over negotiable documents has less significance, and an exception may be justified. Thus, the rule is inapplicable where the tangible assets are assets other than inventory and the direct security right (that is, the security right of the secured creditor not in possession of the negotiable document) was made effective against third parties before the earlier of: (a) the time the asset became covered by the negotiable document; and (b) the time when an agreement was made between the grantor of the security right and the secured creditor in possession of the negotiable document providing for the asset to be covered by the negotiable document, so long as the asset became so covered with a specified short period of time (such as 30 days) from the date of the agreement. In this particular case, the normal “first-in-time” priority rule would apply, and the first creditor to make its security in the tangible assets (whether directly or through taking security in a negotiable document representing those assets) effective against third parties will have priority. This exception provides a level of protection for holders of security rights in tangible assets other than inventory against situations in which the grantor, without notifying such holders and without their authorization, causes the assets to be covered by a negotiable document. For these reasons, the Guide also recommends that such an exception be adopted (see recommendation 106, second sentence).

C. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/637 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.*]