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Draft Practice Guide to the UNCITRAL Model Law on Secured Transactions

Note by the Secretariat

Contents

I. Introduction

A. Purpose of the Practice Guide

What this Practice Guide is about

1. The Practice Guide to the UNCITRAL Model Law on Secured Transactions (the "Practice Guide") provides practical guidance to parties involved in secured transactions (referred to in this Practice Guide broadly as "users" also to include other relevant parties affected by such transactions) in States that have enacted the UNCITRAL Model Law on Secured Transactions (2016) (the "Model Law").[1]

2. While the Practice Guide builds on the Model Law, it does not attempt to supplement the rules therein or suggest any changes to the provisions of the Model Law.

3. The Practice Guide:

- Explains key features and benefits of the Model Law
- Describes the types of secured transactions that creditors and other businesses can undertake under the Model Law and
- Provides step-by-step explanations on how to engage in the most common and commercially important transactions.

Who this Practice Guide is for

4. The Practice Guide is addressed to those that may not be familiar with the Law and thus explains the operation of the Law in general fashion and in plain language. Chapters I and II provide useful guidance to users, for example, financiers and businesses engaged in secured transactions, whereas Chapter III is intended principally for prudential regulatory authorities and regulated financial institutions. In general, the Practice Guide also provides useful information to other relevant stakeholders, for example, policymakers and legislators in States that are considering the adoption of the Model Law as well as judges and insolvency administrators implementing the provisions of the Law.

How this Practice Guide is organized

5. Chapter I explains what a secured transaction is, describes situations where the Law would apply, illustrates the key features and benefits of the Law, and lists the types of secured transactions that are possible under the Law, in particular those that may not have been available before the enactment of the Law.

6. Chapter II explains in practical terms how to do a number of common and commercially important types of secured transactions under the Law. Chapter II is supplemented by examples of a security agreement, diligent certificate [and …] in the Annex.

7. Chapter III illustrates how the Law interacts with the State's prudential regulatory framework.

What the Practice Guide does not deal with

8. The Practice Guide provides guidance on the fundamentals of good lending practices only to the extent that they involve a security transaction element. The Practice Guide focuses on secured lending and the legal relationships that arise from such transactions. It does not address lending in general, particularly "unsecured" lending, and the relationship that arises between the lender and the debtor. Similar to

[1] Accordingly, the Practice Guide uses the term "Law" to refer generally to legislation governing security rights in a State that has enacted the Model Law (including the Model Registry Provisions therein).

the Model Law, which addresses secured transactions involving movable assets, the Practice Guide does not address secured transactions that utilize immovable or real property as collateral.

[*Note to the Working Group: The Working Group may wish to consider whether to retain this paragraph in the Practice Guide and if so, whether to elaborate on what Chapter III does not intend to address.*]

B. Secured transactions and the Law

1. The Model Law and work by UNCITRAL in the area of secured transactions

9. In order to assist States in undertaking secured transactions laws reform, UNCITRAL has prepared a number of relevant instruments including the Model Law. While addressed mainly at policymakers and legislators of States that have not yet adopted the Model Law, these instruments may provide helpful background to readers who want to deepen their understanding of the policies and principles underlying the Model Law.

Legislative Guide on Secured Transactions (2007) ("Secured Transactions Guide")	• Provides guidance with respect to security rights in movable assets, thus enhancing the availability of affordable secured credit • Includes commentary and legislative recommendations to assist States in modernizing their domestic secured transactions law
Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property (2010) ("IP Supplement")	• Provides guidance to facilitate extension of secured credit to intellectual property right holders using such rights as collateral • Includes commentary and recommendations dealing specifically with security rights in intellectual property as well as the law applicable
Guide on the Implementation of a Security Rights Registry (2013) ("Registry Guide")	• Provides commentary and recommendations on the establishment and operation of an efficient and accessible security rights registry, thus increasing transparency and certainty of security rights
UNCITRAL Model Law on Secured Transactions (2016) ("Model Law")	• Provides a comprehensive set of legislative provisions for enactment by States to deal with security interests in all types of movable assets • Includes Model Registry Provisions dealing with the registration of notices in a publicly accessible security rights registry
Guide to the Enactment of the Model Law (2017)("Guide to Enactment")	• Provides guidance to States in their enactment of the Model Law • Explains briefly the thrust of each provision of the Model Law and its relationship with the corresponding recommendations of the Secured Transactions Guide

10. In addition, the United Nations Convention on the Assignment of Receivables in International Trade (the "Assignment Convention") was adopted in 2001 providing uniform rules on the assignment of receivables, thus facilitating increased access to credit through receivables financing.

2. Key benefits of the Law in providing a comprehensive and flexible secured transactions regime

Importance of the Law in relation to access to credit

11. The availability of credit has a significant impact on the economic prosperity of a State. If credit is readily available at a reasonable cost, it promotes the development and growth of businesses in that State, particularly small and medium-sized enterprises (SMEs). A legal system that facilitates secured transactions enables businesses to use their assets as security in a way that can increase their ability to obtain credit at a lower rate. Research shows that in developed economies, borrowers with collateral obtain 9 times as much credit as those without it. They also benefit from repayment periods 11 times as long and up to 50 per cent lower interest rates.[2]

12. The following lists some key features of the Law in providing businesses the ability to engage in secured transactions that may not have been possible under previous regimes.

Almost any type of movable asset can be used as collateral

13. The Law makes it possible for businesses to provide almost any type of movable asset as collateral (art. 8). Movable property, rather than land or buildings, account for most of the capital stock held by businesses and constitute an especially large share for SMEs. In the developing world, 78 per cent of the capital stock of businesses is typically in movable assets such as machinery, equipment or receivables. Under the Law, it is possible for businesses to give a security right in:

- Inventory and other goods
- Receivables and other rights under contracts
- Bank accounts and
- All types of intellectual property.

Security right without possession

14. In addition, the Law makes it possible to take security over an asset without taking physical possession of it (art. 6(1)). This means, for example, that a business can grant a security right over its asset and continue to use it in its operations, rather than transfer the possession of it over to the secured creditor.

Security rights over future assets

15. The Law also makes it possible for a business to give security over an asset that it does not yet own (for example, future inventory), subject to the security right being automatically attached to that asset as soon as the business acquires rights in it (art. 6(2)).

Parties can structure their arrangements to suit their purposes

16. Another distinctive characteristic of the Law is that it enables parties to structure their relationship between themselves as they wish (art. 3), often referred to as party autonomy or freedom of contract. With only a few exceptions, the Law allows parties to vary by agreement the effect of the Law as between them (see also para. 30 below). One exception is the general standard of conduct, which requires parties to exercise their rights and perform their obligations under the Law in good faith and in a commercially reasonable manner (art. 4). This principle is particularly important with regard to the enforcement of a security right and is further discussed in Chapter II.G (for example, see para. 252 below).

[2] Information available at http://www.doingbusiness.org/data/exploretopics/getting-credit/why-matters.

[*Note to the Working Group: The Working Group may wish to note that the possibility to create a security right over grantor's all asset is discussed in Chapter II.E. The Working Group may wish to consider whether it should be highlighted as a novel feature in this Chapter (see para. 25 below)*]

3. The notion of a "security right" under the Law

What is the meant by a "security right"

17. A security right is an interest in an asset that a person (the secured creditor) can exercise to recover money it is owed by another person (the debtor), if the debtor defaults. In essence, a security right assists the secured creditor in protecting itself against the consequences of the debtor's default, because the value of the asset provided for security purposes (the collateral or the encumbered assed) functions as a backup if the debtor cannot or does not pay. A person that grants a security right over the collateral (the grantor) is usually the debtor, but this may not necessarily be the case.

18. A wide range of mechanisms have been developed to allow creditors to protect themselves against the risk of debtor's default, a traditional example being the possessory pledge. The Law covers all such mechanisms as they apply to any interest or right in a movable asset that serves a security function. Based on that approach, often referred to as the "functional, integrated and comprehensive" approach, the Law treats all such interests as security rights. In other words, the Law applies to all rights in movable assets that are created by agreement and that secure the payment or performance of an obligation, regardless of the type of transaction or the terminology used.

Security rights based on ownership of the asset

19. There are some types of transactions that produce the same or an equivalent commercial effect (thus serving a security function), although they might not have been considered as secured transactions traditionally. Finance leases or sales of goods on retention-of-title terms are such examples.

20. Under a finance lease of an automobile, the finance company (the lessor) takes ownership of the automobile during the duration of the lease, while the lessee operates the car. Under a retention-of-title sale, the automobile manufacturer (the seller) may retain ownership of the automobile until the buyer repays the full purchase price of the car.

21. From a commercial perspective, title or ownership of the automobile under these transactions serves the same function as a security right. The lessor and the seller are not retaining title to obtain the goods at the end of the transaction. Rather, they retain title as a security mechanism, so they can repossess the asset if the lessee or the buyer defaults. Because these arrangements are functionally equivalent to a security transaction, the Law applies to them as well.

22. In other words, the lessor under a finance lease, or the seller under a retention-of-title sale, is treated as if it only held a security right in the asset (a secured creditor), and the lessee or the buyer is treated as if they were the owner, and as the grantor of the security right. This is an example of the "functional approach" in action. This approach may be novel in many jurisdictions that have yet to adopt the Model Law.

Outright transfers of receivables

23. The Law also applies to outright transfers of receivables by agreement (art. 1(2)), even though an outright transfer of a receivable does not secure the payment or other performance of an obligation. This means that a person who transfers a receivable outright (the transferor) is generally treated as though it had granted a security right over the receivable, and the transferee as though it only holds a security right over the receivable (and thus not as the owner). One of the reasons for this approach is because it is often extremely difficult to tell whether a transfer of a receivable is an

outright transfer, or a transfer by way of security. Applying the Law to all transfers of receivables reduces the need to make this at times difficult distinction.

24. A key practical consequence of this approach is that the transferee would need to register a notice in the security right registry to make the transfer effective against third parties. If not, the transferee could be defeated by a third party who takes a competing interest in the receivable. This requirement of publicity of outright transfer of receivables may also be a legal novelty in a number of jurisdictions.

4. Examples of transactions facilitated by the Law

25. It would not be feasible or practical for the Practice Guide to list all the types of transactions that are possible under the Law (see also Chapter II.B). Rather, the Law will allow a security right to be taken over a movable asset for almost any purpose, and in almost any way. For example, the Law makes it possible for a grantor to engage in transactions that would grant a security right over:

- An asset that the grantor already owns
- An asset that the grantor acquires with the proceeds of the secured loan
- Its inventory, including inventory that the grantor does not yet own but may acquire in the future
- Its receivables, including receivables that the grantor might not yet own but may acquire in the future
- Its rights under one or more contracts or
- All its movable property, both present and future.

5. Comprehensive and coherent set of third-party effectiveness and priority rules

Priority competitions

26. The Law permits the creation of more than one security right over the same asset in order to utilize the full value of the asset. Therefore, there may be instances where there is a competition between more than one security right created by the same grantor in the same asset.

27. The Law contains a comprehensive set of rules to address such situations. The general rule is that priority between competing security rights is determined by the order in which the security right was "made effective against third parties." The Law provides a number of means to make a security right effective against third parties, with the primary method being registering a notice in the security rights registry (art. 18, see section C below).

Buyers, lessees and licensees of the collateral

28. Under the Law, it is possible that the collateral is sold, leased or licensed to a third party. Therefore, the Law also provides rules on whether the party that acquires a right over the collateral is bound by the existing security right (art. 34). As a general rule, a security right made effective against third parties prior to the sale, lease or license of the collateral would not be affected and the buyer or the transferee would acquire the collateral subject to the security right.

29. There are, however, a few exceptions. In particular, if a person purchases a tangible collateral from a grantor in the ordinary course of the grantor's business, then the buyer will normally be able to take the asset free of the security right. For example, a person who buys goods from a retailer can take the goods free of any security right that the retailer might have given over them, thus reflecting normal commercial expectations.

6. Efficient enforcement of security rights

30. The Law provides a rather liberal approach on how a secured creditor could enforce its security right. Under the Law, parties are given maximum flexibility in structuring how a security right could be enforced, provided that their agreement does not prejudice the rights of third parties or the mandatory rights and obligations of the parties under the enforcement provisions of the Law.

31. In exercising its security right after default by the debtor, a secured creditor need not necessarily apply to a court or other authority (art. 73(1)). Such out-of-court or extrajudicial enforcement, which makes it quicker and more efficient for a secured creditor to recover what it is owed, may be viewed as a significant change in a number of jurisdictions. To minimise the risks that could be posed by misuse of such out-of-court enforcement mechanisms, the Law imposes a number of conditions on how a secured creditor could go about exercising its right (see Chapter II.G).

C. The security rights registry

1. Benefits of the Registry and the Registry as the cornerstone of the Law

32. A secured creditor will want to make sure that its security right is effective against third parties, as the security right will otherwise not be of much benefit. In order to do so, it would have to ensure that third parties are informed of its security right over the asset. As mentioned previously, the most usual way to make a security right effective against third parties under the Law is by registering a "notice"[3] in the general security rights registry (the "Registry")[4] (on how to search and register a notice, see respectively Chapter II.D and F).

33. Unlike other secured transactions regimes where the registration of a security right is a requirement for creating a security right, registration of a notice is not a pre-requisite under the Law for creation of a security right, which only requires the agreement of the parties. Registration of a notice makes the security right effective against third parties.

34. The Registry is generally accessible to the public and its content can be searched by anyone (art. 5 of the Model Registry Provisions). Accordingly, registration of a notice in the Registry provides a form of publicity to third parties that the secured party might hold a security right in a grantor's property. This, in turn, reduces the risk that a third party might be misled into believing that the grantor had clear title to the property, as the third party can search the Registry to see whether notices have been registered against the grantor.

2. Key features of the Registry

Fully electronic and accessible online

35. The Registry is fully electronic, meaning that the information in the registered notices is stored in electronic form in a single database. This ensures the reliability and cost-effectiveness of the Registry.

36. The Registry is also accessible electronically, meaning that registrations and searches can be done online or via a direct networking system for registered/bulk users. This allows registrants and searchers to access the Registry both quickly and confidently, and makes the Registry easy to use.

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[3] A "notice" is defined as a communication in writing (art. 2 (x)) containing certain information about the security right (arts. 8, 17, 19 of the Model Registry Provisions).

[4] Section C assumes that the Law incorporates the Model Registry Provisions of the Model Law and that the enacting State has fully implemented the recommendations in the Registry Guide as well as the Guide to Enactment with regard to the Registry.

Registration of a "notice" and not relevant documents

37. The registrant (usually the secured creditor or its representative) registers a notice in the Registry by submitting the information required (see paras. 189–190 and 195–205 below). Registration of a notice does not require the written consent of the grantor, nor the registration of relevant documents (for example, the security agreement).

38. This means that there is no need to register or attach underlying documents and furthermore, that such documents would not be scrutinized by the Registry. Instead, what is registered and made public through the Registry is basic information about the security right to which it relates. This makes the registration process both quick and easy.

Registration "at any time" even before entering into the transaction

39. Under the Law, a registrant can register a notice at any time. The registrant may register a notice even before the conclusion of the security agreement. Users should be particularly aware of this feature (referred to as "advance registration"), which may be new in a number of jurisdictions.

40. As mentioned above (see paras. 26 and 27), the priority among competing security rights is usually determined by order of registration in the Registry. Accordingly, a secured creditor would usually want to register a notice as early as possible. By allowing advance registration, the Law makes it possible for the secured creditor to fix its priority position before it commits itself to the transaction, so that it can be confident of its priority, when it enters into the transaction.

41. A consequence of this feature is that not all security rights registered in the Registry might actually have been created. In other words, registration of a notice does not necessarily mean that the related security right actually exists. In order to determine whether the security right actually exists, the searcher would usually need to contact the grantor and/or the secured creditor as identified in the notice.

Notices are indexed and searchable according to the name or other identifier of the grantor and not the collateral (grantor-based organization of the Registry)

42. Registered notices are indexed by reference to the name or other identifier of the grantor, and not by reference to the collateral, even though the asset is described in the notices. If a person wants to see whether an item of a grantor's property might be subject to an existing security right, it would need to search against the name of the grantor and analyse the search result to assess whether the asset is covered by any of the notices.

D. Glossary

[*Note to the Working Group: The Working Group may wish to consider whether the list of terms below is appropriate, whether the definitions in relation to outright transfer of receivables (currently in square brackets) should be retained and the placement of the glossary in the Practice Guide.*]

43. The Practice Guide uses terminology carefully defined in article 2 of the Model Law. However, it aims to provide additional clarification of those terms, possibly through examples. In particular, if specialized terms are used, they are explained in the context in which they are raised in the Practice Guide.

44. Readers are also advised to take a closer look at the precise wording of the Law in their State and how it is interpreted in the context of their State's laws as a whole, to better understand how it would operate in their State.

45. The following is a list of key terms used in the Practice Guide.

Term	What it means, broadly
Debtor	A person who owes payment or other performance of the secured obligation. While the debtor will usually be the person who gives the security (i.e., the grantor), this won't always be the case.
Default	The failure of a debtor to pay or otherwise perform a secured obligation. It may also include any other event that the grantor and the secured creditor has agreed as constituting default.
Encumbered asset or Collateral	A movable asset that is subject to a security right. The term includes a receivable that is the subject of an outright transfer by agreement.
Equipment	A tangible asset [other than inventory or consumer goods] that is primarily used or intended to be used in the operation of business
Future asset	A movable asset, which does not exist or which the grantor does not have rights in or the power to encumber at the time the security agreement is concluded
Grantor	A person who creates a security right to secure an obligation that it owes, or that is owed by another person. A buyer or other transferee of an encumbered asset that acquires its rights subject to a security right. The terms borrower, debtor or buyer are used in the Practice Guide to refer to the grantor. [a transferor under an outright transfer of a receivable by agreement]
Inventory	Tangible assets held for sale or lease in the ordinary course of business, including raw materials and work in process
Movable asset	A tangible or intangible property, which is not immovable property
Possession	Actual possession of a tangible asset by a person or its representative, or by an independent person that acknowledges holding it for that person
Proceeds	Anything that is received in respect of an encumbered asset for example, through its sale or other transfer
Priority	The right of a person in a collateral in preference to the right of a competing claimant
Receivable	A right to payment of a money [excluding a right to payment evidenced by a negotiable instrument, a right to payment of funds credited to a bank account and a right to payment under a non-intermediated security]
Secured creditor	A person who has or has the benefit of a security right. The terms creditor, lender, financier or supplier are also used in the Practice Guide to refer to the secured creditor. [A transferee under an outright transfer of a receivable by agreement]
Security agreement	An agreement between a grantor and a secured party to create a security right, whether or not the parties call it a security agreement [An agreement that provides for the outright transfer of a receivable]

Security right	A property right in a movable asset, created by a security agreement, that secures payment or other performance of a secured obligation [The right of the transferee under an outright transfer of a receivable by agreement] This is regardless of whether the parties call it a security right, and regardless of the type of asset, the status of the grantor or secured creditor, or the nature of the secured obligation.

E. Interaction of the Law with other laws including international instruments applicable in that State

46. Readers should be reminded that the Law may not necessarily be an entirely independent legislation and may be part of a set of laws or regulations of that State. It should also be noted that some provisions in the Model Law contain options. Where this is the case, the Practice Guide explains how users could deal with the various options. However, readers will need to first determine which option their State has adopted in their Law.

47. The Law does not operate in a vacuum and is usually part of the general legal framework in a given jurisdiction. In fact, the success of the secured transactions legal framework will depend on the compatibility and consistency between the Law and other laws in that jurisdiction. As such, secured transactions under the Law are necessarily affected by other laws that govern relevant parties as well as credit and financial transactions. Readers must consider all relevant legislation in order to understand the various possibilities and the consequences.

48. Depending on the jurisdiction, the range of laws that interact with the Law would generally vary. Nonetheless, the following are some examples of laws that users may need to make reference to: contract law, law of obligations, law of guarantees, property law, intellectual property law, negotiable instruments law, immovable property law, consumer protection law, insolvency laws, financial regulations, civil procedure law and others. International treaties and conventions applicable in that State may also need to be taken into account.

[*Note to the Working Group: The Working Group may wish to consider whether the list above is sufficient or the list would need to be further elaborated as below.*]

49. Secured transactions involve contracts, obligations and the use of different types of assets as collateral. Consequently, the design and execution of the transaction must take into consideration contract law and the law of obligations. Often, security rights are created alongside guarantees to enhance the availability of credit, which means that the law of guarantees may also need to be considered. Depending on the type of collateral, other laws may need to be consulted, such as property law, intellectual property law, securities law and negotiable instrument laws.

50. There may be limitation as property of certain individuals may be protected or exempt from enforcement, an element that will need to be considered by lenders when conducting due diligence. Consumer protections laws may also apply to certain group of debtors. Financial regulations will impact how banks approach lending, monitoring of credit and enforcement.

51. Disputes arising from secured transactions as well as the judicial exercise of a security right would usually be subject to relevant civil procedure laws. In the case of insolvency of the debtor, lenders would need to be aware of the extent to which insolvency law recognizes security rights as well as its priority (also avoidance actions). In rare circumstances, criminal and administrative law may also have an impact. For example, certain acts may be subject to criminal or administrative

sanctions, and security rights over concession rights may be shaped by the relevant administrative legislation.

International treaties and conventions

52. It may also be necessary to take into account international treaties and conventions applicable in the State that relate to cross-border secured transactions.[5] These international instruments include:

- Convention on International Interests in Mobile Equipment (2001) and its Protocols
- Unidroit Convention on Substantive Rules for Intermediated Securities (2013, Geneva Convention)
- Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (2006, Hague Securities Convention)
- United Nations Convention on the Assignment of Receivables in International Trade (2001, Assignment Convention) and
- United Nations Convention on Contracts for the International Sale of Goods (1980, CISG).

F. Issues arising from cross-border transaction

[*Note to the Working Group: The Working Group may wish to consider whether to retain this section in Chapter I or to combine with Chapter II.I.*]

53. A transaction that involves connections with more than one State is often referred to as a "cross-border" transaction. In such cross-border transactions, it is necessary to determine which State's law will apply to the creation, third-party effectiveness, priority and enforcement of a security right. The Law provides rules that determine the applicable law in Chapter VIII (Conflict of Laws). The following examples illustrate the operation of some of those rules. Let's assume that State O has enacted the Model Law.

<Example 1> X is a distributor of computers and administers its business from an office located in State O. X has stores in State O and in State P, where it offers the computers for sale. X wishes to obtain credit from Y and grant a security right in the computers held as inventory in stores located in States O and P.

<Example 2> X sells on credit the computers held as inventory in its stores in States O and P to customers whose billing addresses are in State O, in State P and in other States. X wishes to grant a security right in the receivables generated from those sales to Y.

<Example 3> X maintains bank accounts with a bank in State O and with another bank in State P. X deposits the amounts received from the collection of its receivables in those accounts. X wishes to grant a security right in the funds credited to its bank accounts to Y.

54. In Example 1, the applicable law is that of the State where X's computers are located (art. 85). This means that in order for the Y's security right to be recognized in State O as being valid and effective against third parties, the requirements of the law of State O would need to be met with respect to the computers held for sale at

[5] To assist users in considering these texts, UNCITRAL, the Hague Conference on Private International Law, and the International Institute for the Unification of Private Law (Unidroit) have prepared a comparison and analysis of major features of international instruments relating to secured transactions (available at http://www.uncitral.org/uncitral/en/uncitral_texts/security/2011UNCITRAL_HCCH_Unidroit_texts.html).

stores in State O, and those of the law of State P with respect to the computers held for sale at stores in State P.

55. In Example 2, the applicable law is that of the State where X has its place of business (arts. 86 and 90). As X has places of business in States O and P, the location of the grantor is the State in which the central administration of X is exercised (that is, the place where the grantor conducts the administration of its business). Therefore, regardless of the fact that the customers of X are located in a number of States, in order for Y's security right in all receivables owing to X to be recognized in State O as valid and effective against third parties, only the requirements of the Law (the law of State O) would need to be met.

56. In Example 3, the Model Law offers two options to enacting States (art. 97). In many circumstances, the choice between options A and B would not matter as both will likely lead to the application of the law of the State where the bank account is maintained. Assuming that law is the applicable law, in order for Y's security right in both bank accounts to be recognized in State O as valid and effective against third parties, the respective requirements of the laws of both State O and State P would need to be met.

57. Under the Law, the location of the secured creditor is not relevant for the determination of the applicable law. Therefore, whether Y in the examples above is based in State O or in another State has no impact on that determination.

58. The Law also includes rules for the determination of the law applicable to the priority and enforcement of a security right (arts. 85, 86, 88 and 97). In the examples, these rules generally lead to the application of the same law as that indicated for the creation and third-party effectiveness of the lender's security right. For cross-border transactions involving assets other than tangible assets, receivables and bank accounts as provided in the examples (notably, tangible assets of a type ordinarily used in more than one State, intellectual property and non-intermediated securities), the Law provides rules that designate a different applicable law.

G. Secured transactions involving financing to micro-business

The need for particular attention to financing of micro-businesses

59. The Law is designed to improve access to finance and to lower the cost of credit for all kind of businesses. It is particularly well suited for SMEs, which are the most common form of businesses and take up a large portion in most States. However, financing to micro-businesses require particular attention because of certain specific features pertaining to such transactions as well as to such businesses (see generally, "Reducing the legal obstacles faced by micro, small and medium-sized enterprises (MSMEs)" (A/CN.9/WG.I/WP.110) — document currently being prepared by Working Group I).

60. While a common method of financing to micro-businesses is often referred to as micro-finance (unsecured lending usually for a very short period and for a very small amount), the Practice Guide focuses only on secured lending to micro-businesses.

61. The precise size and nature of micro-businesses would be different in each State and would largely depend on the economy and relevant policies of that State. However, micro-businesses can be generally characterized as smaller businesses, which exhibit some or all of the following features:

- Individual entrepreneurs or family businesses, where most often the fate of the entire household is at stake (very little distinction between the business and its owners)

- Require loans of small amounts and for a very short term

- More likely to change legal status, name and address, particularly where they are sole entrepreneurs
- Insufficient or inappropriate property to provide as collateral (most likely fluctuating assets such as inventory and receivables)
- Limited financial information or those of poor quality and
- Weak bargaining position vis a vis lenders.

62. Furthermore, in such transactions:

- The overhead costs of lending may not be covered by the small amounts at stake
- The small size and informality of a micro-business means that lenders are tempted to omit the individual assessment of an application for finance and of the collateral offered by those businesses
- There is a higher possibility to overlook the monitoring of the life-cycle of the credit
- Personal guarantees are usually required by lenders (in addition to security rights) from the company director/shareholder and from family members and
- The close link between the business's finances and the personal finances of the family raises specific issues on enforcement of security rights.

Advantages of the Law for micro-businesses

63. When micro-businesses need general financing (in contrast to financing for the acquisition of specific assets), the lack of available assets for collateral can be a major problem. The Law enhances access to finance for such businesses by enabling any type of collateral to be given, including all asset security rights (see para. 13 above). The Law also enables security to be given over future assets (see para. 15 above) as well as circulating assets such as inventory, receivables and cash. This opens new financing opportunities, since receipt of funds will be linked to future business activities, rather than to their scarce existing assets. Further, the Registry keeps transaction costs low (an essential feature given the small amounts at stake) enabling lenders to ensure priority over other claims to the collateral, lowering their risk and hence reducing the cost of credit.

Typical issues that arise in secured financing to micro-businesses

64. Due to the specific nature of secured financing to micro-businesses, ways to engage in secured transactions as generally discussed in Chapter II might need to be further tailored. For example, due diligence, monitoring of collateral and enforcement would need to take into account additional aspects.

65. As noted, financing to micro-businesses will usually be of small amounts and thus should be simpler and less costly. This may call for preparation of relevant templates by chambers of commerce, association of financing institutions or even by governmental or non-governmental organizations promoting entrepreneurialism, written in plain and clear language and understandable to micro-businesses.

66. Guarantees are ubiquitous in the financing to micro-businesses. While they enhance the assets available for repayment and reduce the borrower's moral hazard by aligning incentives, the provision of guarantees effectively removes limited liability, and default often causes dramatic financial problems in the households of the individuals involved. Furthermore, the general financial distress of micro-businesses tend to generate societal problems as well as economic ones. In that context, ways to minimize the abuse of personal guarantees and to coordinate the insolvency proceedings of the guarantor and the micro-business may need to be considered.

67. The lack of financial information and the asymmetry of bargaining power may result in lenders not performing adequate due diligence on the borrower, thus

imposing terms and conditions unjustified by the level of real risk inherent in the operation of the micro-businesses. The requirement of excessive amounts of collateral in comparison to the amount of the loan (referred to as “over-collateralisation”) may be hazardous in many jurisdictions, particularly in developing and middle-income States (see also paras. 136–138 below). Over-collateralisation may severely restrict access to finance to micro-businesses even under the Law, damaging the overall economy as a consequence.

II. How to engage in secured transactions: guidance on contractual and transactional issues

68. This Chapter will explain in practical terms how parties can engage in a number of key secured transactions under the Law. Chapter II is supplemented by samples of a security agreement, diligent certificate [and …] in the Annex.

69. Unless otherwise mentioned, the Practice Guides uses the following Scenario as its basis for explaining how transactions may take place.

<Scenario>

A company manufacturing goods (X) is seeking to obtain a loan from a local bank (Y) for its business operation based on a piece of equipment that X owns in its manufacturing facility in State O.

A. Secured transactions under the Law: The fundamentals

1. How to create a security right (arts. 6–17)

70. Under the Scenario, X and Y would conclude a security agreement to create a security right over the equipment (art. 6(1), for more detail, see Section E below). The security agreement would need to contain minimum required information identifying the secured creditor and the grantor. It would need to describe the obligation being secured as well as the collateral.[6] The security agreement should be in writing and would usually be signed by both X and Y (art. 6(3)).

71. The Law provides an exception to the writing requirement and that is when Y is in possession of the collateral (art. 6(4)). Considering that X would need to utilize the equipment in its operation, this may not be practical. In that sense, it should be emphasized that the Law gives full effect to non-possessory security rights, which allows grantors to retain possession of the collateral while endowing a security right to the creditor.

72. In order for Y to obtain an effective security interest, X should have rights in the equipment or the power to encumber it (art. 6(2)). In other words, it is not necessary that X has ownership over the equipment. For example, it may have a lease over the equipment.

73. If the equipment is owned by a third person (Z), it is also possible for Z to grant a security right over the equipment to secure the loan that X obtains from Y. The debtor (X) does not always have to be grantor (Z) and vice versa.

74. As mentioned (see para. 15 above), a security right may be created over future assets. For example, X may conclude a security agreement with Y to create a security right over goods that it will manufacture using the equipment or another piece of equipment that it will purchase in the future. In both cases, the security right is not

[6] In States that have enacted article 6(3)(d) of the Model Law, the security agreement would need to state a maximum amount for which the security right can be enforced. This could general facilitate the grantor’s access to financing from other creditors when the value of the collateral is greater than the amount indicated in the security agreement (see Guide to Enactment, para. 89).

created at the time of the conclusion of the agreement but when the goods are manufactured and when X acquires rights in the new piece of equipment (art. 6(2)).

2. How to make a security right effective against third parties (arts. 18–27)

The distinction between creation and effectiveness against third parties

75. Under the Law, the creation of a security right (and thus effectiveness of the security right against the grantor) is distinguished from its effectiveness against third parties ("third-party effectiveness"). By doing so, it reduces the formalities required to create a security right, while at the same time giving all third parties with a right in that asset an inexpensive and reliable means to determine whether the asset may be subject to a security right. Accordingly, the Law provides a separate set of rules on the making the security right effective against third parties.

76. Quite logically, the creation of a security right is a pre-condition for it to be made effective against third parties. For example, even if Y registers a notice in the Registry without concluding a security agreement, its security right would not be effective against third parties because the security right itself had not been created. There may be instances where the creation and the third-party effectiveness may be achieved at the same time. For example, if Y registered a notice over X's to-be manufactured goods and concluded a security agreement to that end, the creation and the third-party effectiveness would both be obtained when the goods are manufactured.

77. While creation and third-party effectiveness are distinguished under the Law, a secured creditor would generally want to ensure that its security right is made effective against third parties. This is because if a security right has been created but not made effective against third parties, it may not be able to fulfil its function of securing payment or other performance of an obligation due to a competing right over the asset held by a third party. For example, if Y concluded a security agreement with X over the equipment but did not make its security right effective against third parties, it might not be protected in situations where X granted another security right on the same equipment, sold the equipment or became insolvent.

78. The creation of a security right by the conclusion of a security agreement is effective only between X and Y. This means that the security right will not be effective against another party who acquires a security right or another type of right in the equipment, such as a buyer or an insolvency representative. In that case, the security right is of little use to Y since recourse to the value of the equipment in the event of default can easily be lost.

79. Therefore, the distinct requirements of creation and third-party effectiveness, which are both easily ascertainable under the Law, need to be met for a creditor to obtain all the advantages of its security right. By making its security right effective against third parties, Y can generally ensure that it will be able to have recourse to the entire value of the equipment, subject to any priority competitions.

How to make a security right effective against third parties

80. The Law provides a number of methods for achieving third-party effectiveness, but the primary method is to register a notice in the Registry (art. 18(1), on how to register a notice, see Section F below). Registration is available for all types of assets, while other methods only apply to certain types of assets as outlined below:

- For tangible asset, by the secured creditor taking possession of the asset (art. 18(2), see paras. 83–84 below)
- For funds credited to a bank account, by concluding a control agreement (see para. 85 below) or by the secured creditor becoming the account holder. However, if the secured creditor is the bank where the account is held, no additional step is required (art. 25)
- For goods covered by a negotiable document, by making the security right in the negotiable document effective against third parties, for example, by the

secured creditor possessing the document (under certain conditions, see arts. 16 and 26, see paras. 123–124 below)

- For uncertificated non-intermediated securities, by concluding a control agreement or notation in the books of the issuer (art. 27).

When to register a notice – at any time

81. Registration can take place at any time, even before the creation of the security right or the conclusion of the security agreement (art. 4 of the Registry Provisions, see paras. 39–40 above). As priority is determined by the date and time of registration (see para. 27 above), it is generally advantageous to register as early as possible.

82. In the Scenario, Y is likely to first search the Registry to see if X has created any other security right in the equipment. It would then register a notice most likely before the conclusion of the security agreement to preserve its priority and in any event, certainly before advancing any funds to X.

Possession

83. Another method of achieving third-party effectiveness is by the secured creditor taking possession of the collateral, as had been the case in traditional possessory pledge. For example, X could transfer the possession of its equipment to Y, but this would generally limit X's ability to use the equipment in its business operation. Having or taking possession of a tangible encumbered asset has the following consequences under the Law:

- There is no need for a written security agreement (art. 6(4)) and

- There is no need to register a notice to achieve third-party effectiveness (art. 18(2))

84. Where the grantor does not require the collateral for immediate use or sale, possession can be a suitable method of achieving third-party effectiveness. Possession need not be necessarily by the secured creditor but also by a third party taking possession on behalf of the secured creditor. The latter would make more sense commercially, particularly if the secured creditor does not have the necessary storage facilities. For example, goods manufactured by X may be stored in a warehouse and the warehouse owner may undertake to hold them on behalf of the Y.

Control agreement

85. A control agreement (see art. 2(g)) refers to an agreement in writing involving three parties: (i) the grantor; (ii) the secured creditor; and (iii) when the agreement relates to funds credited to a bank account, the bank (deposit-taking institution) and when it relates to uncertificated non-intermediated securities, the issuer of the securities. A control agreement would provide that the bank or the issuer would follow the instructions of the secured creditor as to what to do with the collateral without requiring any further consent from the grantor.

Changes in methods of achieving third-party effectiveness

86. It is possible to change from one method of achieving third-party effectiveness to another and retain the third-party effectiveness from the date it was first made effective against third parties (art. 21). In practice, this is most likely to occur when the first method used by the secured creditor was to take possession of the collateral. If the secured creditor registers a notice before transferring possession of the collateral (in most cases, back to the grantor), the third-party effectiveness would remain even though the secured creditor may no longer have possession. The third-party effectiveness would have been achieved as of the date that the secured creditor obtained possession of the collateral.

How to make a security right in proceeds effective against third parties

87. Under the Law, a security right in an asset extends to its identifiable proceeds (art. 10).[7] For example, if X sold its equipment, Y's security right would extend to the sale price received by X through the sale. If the equipment was damaged due to a fire, Y's security right would extend to any related insurance claims. In essence, Y's security right would extend to anything in whatever form that is received by the X (see paras. 214–216 below). [*Note to the Working Group: This paragraph, which might be better placed in Section A.1, is placed here in conjunction with the following paragraph to keep them concise.*]

88. As to the third-party effectiveness of the security right, if Y had registered a notice with regard to the security right in the equipment, and if the proceeds received by X are in the form of money, receivables, negotiable instruments or funds in a bank account, Y does not need to do anything more to make its security right in the proceeds effective against third parties (art. 19(1)). However, if the proceeds are another type of asset (for example, if the equipment was exchanged with another piece of equipment), Y would have a short grace period during which it needs to use one of the methods mentioned (see para. 80 above) to make its security right in the other piece of equipment effective against third parties (art. 19(2)).

89. Another convenient way for Y to ensure the third-party effectiveness of its security right over any proceeds would be to describe them as original encumbered assets in the security agreement as well as in the registered notice.

B. Different types of financing facilitated by the Law

90. There are a wide array of financing techniques being used currently and many of them are facilitated by the Law. Prior to the enactment of the Law, some of these transactions may have been characterized as secured transactions, while others may not have. Under the Law, they would all be considered as transactions that serve a security purpose, in other words, creating a security right.

91. In order to illustrate the range of transactions that the Law could facilitate, some of the financing techniques are described below. It is, however, important to note that these examples represent only a few examples of transaction currently in use and possible under the Law.

1. Acquisition financing

92. Businesses often obtain financing to acquire inventory, equipment or other assets. In the Scenario, X may require additional pieces of equipment to expand its business operation. In that case, financing could be provided by the seller of the equipment. In other cases, the financing could be provided by a lender including Y. The lender may be a bank or other independent third party, but it may also be an affiliate of the seller, a captive finance company owned by the seller to encourage and facilitate sales of its products.

93. Consistent with long-standing practice in many jurisdictions, the seller may retain title to the equipment to secure the payment of the purchase price. These are often referred to as sale on "retention-of-title" terms or retention-of-title transactions. In many other cases, the seller or lender that provides financing is granted a security right in the acquired assets to secure the repayment of the loan.

94. The following are some illustrations of acquisition financing, whereby X wishes to acquire certain inventory and equipment for use in its manufacturing operations.

95. X wishes to purchase paint (raw material, and therefore inventory) from vendor A. Under the purchase agreement, X is required to pay the purchase price for

[7] Proceeds also include proceeds of proceeds, for example, a piece of equipment purchased with money derived from the sale of an encumbered asset (art. 2(bb)).

the paint within 30 days of A's invoice to X and X grants a security right in the paint to A to secure the payment of the purchase price.

96. X also wishes to purchase drill presses (equipment) from vendor B. Under the purchase agreement with B, X is required to pay the purchase price for the drill presses within 60 days following their delivery to X's factory. The purchase agreement also provides that, until the purchase price is paid in full, B retains title to the drill presses.

97. X also desires to purchase certain conveyors (equipment) from vendor C. Under the purchase agreement with C, X is required to pay the purchase price for the conveyors when they are installed in X's factory and rendered operational. X obtains a loan from D to finance the purchase and installation of the conveyors from C, which is secured by a security right in the conveyors.

98. Finally, X wishes to lease computer equipment from vendor E. Under the lease agreement with E, X leases the computers for a period of two years, during which X is required to make monthly lease payments. X has the option (but not the obligation) to purchase the computers for a nominal purchase price at the end of the lease term.[8] The lease agreement provides that E would retain title to the computer during the term, but that title will be transferred to X at the end of the term if X exercises the purchase option. This type of lease is often referred to as a "finance or financial lease."[9]

99. In all of the above examples, the acquisitions by X are made possible by means of acquisition financing provided by another entity (seller, lender or financial lessor), which each holds a security right in the acquired assets to secure the obligations owed to it. The Law treats all of these transactions as those that give rise to an "acquisition security right" subject to the same rules.[10] This is referred to as the "unitary approach". [*Note to the Working Group: The Working Group may wish to consider whether the Practice Guide should include an illustration of the non-unitary approach as discussed in the Secured Transactions Guide.*]

Super-priority of an acquisition security right (art. 38)

100. The general rule is that priority between competing security rights is determined by the order in which the security right was made effective against third parties. The most important exception to that general rule relates to acquisition security rights.

101. The Law provides that if specified conditions are met, an acquisition security right has priority over a competing non-acquisition security right in the same asset including a security right previously registered which would otherwise have priority under the general rule.[11] In short, it gives advantageous treatment to acquisition finance.

102. Suppose that X had obtained a loan from Y and it had granted a security right over all its present and "future" assets, including any equipment or inventory that X might purchase in the future. Y registered a notice on 23 January 2019 and the security agreement was concluded on 30 January 2019.

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[8] It may also be possible that the title to the computers may be transferred to X automatically at the end of the lease term.

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

[10] "Acquisition security right" is defined as "a security right in a tangible asset, or in intellectual property or the rights of a licensee under a licence of intellectual property, which secures an obligation to pay any unpaid portion of the purchase price of an asset, or other credit extended to enable the grantor to acquire rights in the asset to the extent that the credit is used for that purpose" (art. 2(b)).

[11] Readers should be advised that article 38 of the Model Law provides two options for States to consider. They should also be advised that the requirement for the super-priority rule differs depending on the types of assets (equipment, inventory and consumer goods) (see Guide to Enactment, paras. 320–329).

103. X purchased the drill presses from B under the terms outlined in paragraph 96 on 30 March 2019. The drill presses were delivered to X's factory on 10 April 2019. Under the general rule, Y would have priority over B, unless B had registered a notice prior to 23 January 2019.

104. However, the Law provides that B has priority over Y, if B has possession of the drill presses (for example, during the period between 30 March 2019 to 10 April 2019). In practice, it is quite unlikely that B would continue to possess the drill presses, as this would deprive X of their use in its operation. B also has priority over Y, if B registers a notice with respect to the drill presses within, for example, 15 days (period specified in the Law) after X took possession of the drill presses on 10 April 2019.

105. With respect to the acquisition of inventory, the Law provides a slightly different rule. Suppose that X purchased 20 cans of paint from A as outlined in paragraph 95 above on 30 March 2019, and they were delivered to X's factory on 10 April 2019. Under the general rule, Y would have priority over A, unless A had registered a notice prior to 23 January 2019.

106. However, the Law provides that A has priority over Y if A is in possession of the 20 cans of paints, which is also highly implausible in practice. However, A can have priority over Y by registering a notice with respect to the paint before they were delivered to X and by informing Y of the sale and A's intention to obtain an acquisition security right in the 20 cans of paint.

2. Inventory and receivable revolving loan financing

107. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a manufacturer can commence operations and sell its products, it must equip a plant, purchase raw materials, incur labour costs to convert the raw materials into finished products and sell the finished products to its customers. Only then will it generate receivables and begin to collect payment from its customers. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections. Moreover, this need is not limited to the initial start-up period. The need for working capital to address the gaps of time inherent in a business's "cash conversion cycle" (acquiring inventory, processing the inventory, selling the inventory to create receivables, receiving payments on the receivables, and acquiring more inventory to begin the cycle again) typically continues during its entire life.

108. One highly effective method of providing such working capital is a revolving loan facility. Under this type of financing, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs. The borrower typically requests loans when it needs to purchase raw materials or pay other expenses relating to the manufacturing of goods. The borrower repays the loans as inventory is sold and receivables are generated and collected. Thus, borrowings and repayments tend to be frequent (although not necessarily regular) and the outstanding amount of the credit is constantly fluctuating. The collateral pool of inventory and receivables also fluctuates as inventory is converted into receivables, receivables are collected, and new inventory is purchased. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle, this type of loan structure is, from an economic standpoint, highly efficient and beneficial to the borrower. It helps the borrower to avoid borrowing more than it actually needs thereby minimizing interest costs.

109. An illustration of this type of financing follows. Suppose that it typically takes four months for X to manufacture, sell and collect the sales price of its products. Y agrees to provide a revolving loan facility to X to finance this operation. Under the loan facility, X may obtain loans from time to time according to a formula. For example, X may borrow up to 50 per cent of the value of its inventory that Y deems acceptable for borrowing (based on various eligibility criteria, such as the type and

quality of the inventory) and up to 80 per cent of the value of its receivables that Y deems acceptable (also based upon various eligibility criteria, such as the creditworthiness of the debtors of the receivables[12]).

110. The percentages that Y is willing to loan against the value of eligible inventory and receivables are commonly called the "advance rates". The aggregate value of eligible inventory and receivables at any given time multiplied by the applicable advance rates is commonly called the "borrowing base". X is expected to repay these loans from time to time as it receives payments of receivables from its customers, so that the outstanding loan balance under the loan facility never exceeds the lesser of (i) the committed amount of the loan facility and (ii) borrowing base. The loan facility is secured by a security right in all of X's existing and future inventory and receivables and all proceeds thereof. In this type of financing, it is also common for the Y to obtain a security right in the right to payment of funds credited to the bank account into which customer payments (that is, proceeds of receivables) are deposited, and a control agreement is signed under which the deposit-taking bank agrees to transfer funds credited to the account to Y on a periodic basis.

3. Factoring

111. Factoring is a highly effective form of receivables financing that can trace its roots back many centuries. In general, factoring involves the outright sale or assignment of receivables by the seller (assignor) to the factor (assignee). As discussed (see paras. 23–24 above), the Law (with the exceptions of arts. 72–82) applies to outright transfers even though it is not a security device. This is because it functions in many aspects as a secured transaction.

112. There are a number of different types of factoring arrangement. The factor may pay a portion of the purchase price for the receivables at the time of the purchase ("discount factoring"). It may pay only when the receivables are collected ("collection factoring"). Or it may pay on the average maturity date of all of the receivables ("maturity factoring").

113. Factoring may be on a "recourse" or a "non-recourse" basis. Under a recourse factoring arrangement, the assignee of the receivables has recourse against the assignor to obtain payment in the event of non-payment by the debtors of the receivables. By contrast, under a non-recourse factoring arrangement, the assignee has no ability to obtain payment from the assignor if the debtors of the receivables fail to pay.[13] Finally, the debtors of the receivables may be notified that their receivables have been the subject of factoring ("notification factoring") or they may not be so notified ("non-notification factoring"). When notice is given to the debtors of the receivables, the notice often is done by requiring the assignor to insert a note, in each invoice that the assignor sends to its customers, that the receivable evidenced by the invoice has been sold to a factor.

114. Although a factoring agreement is fundamentally a financing arrangement under which a business can obtain immediate cash for the receivables it generates, the factor may also perform various other services for the assignor relating to the receivables. These additional services may include approving and evaluating the creditworthiness of the debtors of the receivables, performing bookkeeping duties and engaging in collection efforts with respect to receivables that are not paid when due. These services can provide a useful benefit to businesses that do not have their own credit and collection departments.

115. Here is an illustration of a typical factoring arrangement. X enters into a discount factoring arrangement with factor F, pursuant to which F agrees to purchase receivables that it deems to be creditworthy. F advances to X an amount equal to

[12] Debtor of the receivables is defined in the Law as a person that owes payment of a receivable, which is subject to a security right (art. 2(i)).

[13] Even in non-recourse factoring arrangements, typically there is limited recourse to the assignor for breach of various representations made by the assignor with respect to the receivables.

90 per cent of the face value of those receivables, holding the remaining 10 per cent as a reserve to cover potential customer claims (such as for defective goods or supplying the wrong goods) that would reduce the value of the receivables. The factoring arrangement is with notification to X's customers and is without recourse to X in the event of non-payment by X's customers.

4. Securitization

116. Another form of financing involving the use of receivables is securitization. Securitization is a sophisticated form of financing under which a company can obtain financing based on the value of its receivables by transferring them to a special purpose vehicle ("SPV") that is wholly owned by the company. The SPV will then issue securities (such as commercial paper) in the capital markets secured by the stream of income expected to be generated by the receivables. This technique is commonly used in situations where a company's receivables consist of credit card receivables, motor vehicle rents or home mortgage loan payments, although the securitization of many other types of receivable is also possible. Securitization transactions are complex financing transactions that are dependent upon both a jurisdiction's securities laws and its secured transaction laws. Where these transactions are sufficiently large, carefully structured and properly monitored, securitization can be a cost-effective form of financing.

117. Securitization is intended to lower the cost of financing because the SPV is structured in a way that significantly reduces the risk of its insolvency by restricting the amount of debt that the SPV can incur and the activities in which it can engage. This structure may significantly reduce the risks that the lender must consider when deciding the economic terms of the securitization facility. In addition, because the source of credit is the capital markets rather than the banking system, securitization often can generate greater amounts of credit at lower cost than normal bank loans.

118. Here is an illustration of a securitization transaction. A SPV is created by a large retail chain to purchase receivables arising from its customers using credit card issued by that retailer and bearing its name. The SPV then issues debt securities, under applicable securities laws, to investors in the capital markets. These debt securities are secured by the income stream flowing from the credit card receivables that have been transferred to the SPV. As payments of receivables are made, the SPV will use the proceeds it receives to make payments on the debt securities.

5. Term loan financing

119. Businesses often need specific financing for large expenditures that are not in the ordinary course of their business. These expenditures may include, for example, the purchase or lease of significant items of equipment, the development of a new product line, or even the acquisition of another business through a purchase of the outstanding shares or the assets of that business. In these situations, businesses generally seek loans that are repayable over a fixed period of time, with principal being repaid in periodic instalments pursuant to an agreed schedule or in a single payment upon the maturity of the loan term.

120. As is the case with many other types of financing, a business that does not have a strong, well-established credit rating will have difficulty obtaining term loan financing unless it is able to grant a security right in its assets in favour of the lender. The amount of the financing available, and its cost to the borrower, will be based in part on the creditor's estimate of the net realizable value of the collateral. In States that have not enacted the Model Law, immovable property may be the only type of asset that is available to, or accepted by, lenders to secure term loan financing. However, many businesses, in particular new ones, do not own any immovable property. As a result, term loan financing is often not available to borrowers that may, nonetheless, have significant assets, such as equipment or the overall value of the entire business. In contrast, the Law facilitates term loan financing secured by

movable assets, such as equipment, intellectual property and the overall value of the enterprise as a whole.

121. Here is an illustration of term loan financing. X desires to expand its operations and purchase another company engaged in a similar operation. X obtains a loan from Y to finance the acquisition. The loan is repayable in equal monthly instalments over a period of 10 years and is secured by all existing and future assets of both X and the company being acquired.

6. Sale and leaseback transactions

122. A sale and leaseback transaction is another method by which businesses can obtain credit based upon its existing tangible movable assets (usually equipment) while still retaining possession of, and the right to use, these assets in its business operation. In a sale and leaseback transaction, X will sell its equipment to a third party for a specific amount, which X may then use as working capital or make capital expenditures. Simultaneously with the sale, X will lease the equipment back from the third party for a lease term, and at a rental rate, specified in the lease agreement. Often, the lease would be a "financial lease" as opposed to an "operating lease" (see para. 98 above).

7. Financing practices involving negotiable documents or instruments

123. Negotiable instruments (such as cheques, bills of exchange or promissory notes) and negotiable documents (such as bills of lading or warehouse receipts that embody rights in goods) may also serve as collateral. Such transactions are facilitated by the Law.

124. Here is an example. In connection with the revolving loan facility (see paras. 107–110 above), X asks Y to provide additional credit based on the value of inventory purchased by X from its overseas supplier while that inventory is in the process of being shipped to X's factory. The goods are evidenced by negotiable bills of lading issued by the carrier. Y may agree to provide such additional credit provided that it obtains a first-ranking security right in the bills of lading and agreements are reached with X's freight forwarder and customs broker to administer the bills of lading as agent for Y.

[*Note to the Working Group: The Working Group may wish to confirm that the Practice Guide need not address the rights of a secured creditor in possession of a negotiable instrument or certificated non-intermediated security in States parties to the Genevan Uniform Law and the Bills and Notes Convention (see Guide to Enactment, paras. 141–142).*]

8. Financing related to intellectual property

125. Intellectual property plays an increasingly important role in businesses of all types. For many businesses, its interest in intellectual property, either as an owner or a licensee, may be the company's most important, or only, asset. It is therefore not surprising that intellectual property is playing an increasingly important role as collateral which can be used to access credit. The Law accommodates this trend, enabling businesses to use their intellectual property as collateral in an efficient and cost-effective way that balances the interest of the companies, the secured creditors as well as the owners of the intellectual property. [14]

126. Secured transactions relating to intellectual property can usefully be divided into two broad categories. The first category consists of transactions in which the intellectual property rights of the borrower (as owner, licensor or licensee of the intellectual property) serve as security for credit. For example, suppose that X is a pharmaceutical company that constantly develops new drugs. It wishes to obtain a

[14] The Law, however, does not apply to security rights in intellectual property in so far as the Law is inconsistent with the law relating to intellectual property as specified in the State (art. 1(3)(b)).

revolving line of credit from Y secured, in part, by X's portfolio of existing and future drug patents and patent applications. X would provide Y with a list of all of its existing patents and patent applications, as well as their chain of title. Y would evaluate which patents and patent applications it will include in the "borrowing base" and at what value they will be included. Y then obtains a security right in the portfolio of patents and patent applications. When X obtains a new patent, it provides its chain of title and valuation to Y for inclusion in the borrowing base. Y evaluates the information, determines how much additional credit it will extend based on the new patent and adjusts the borrowing base accordingly.

127. The second category involves financing transactions that involve intellectual property in combination with other movable assets, such as equipment, inventory or receivables. In such transactions, the value of the collateral is based, to some extent, upon the intellectual property with which they are associated. This category of transactions usually involves security rights in tangible assets.

128. Suppose that X is a manufacturer of designer jeans and other high-fashion clothing. X wishes to borrow money from Y secured, in part, by X's inventory of finished products. Many of the items manufactured by X bear well-known trademarks licensed from third parties under licence agreements that give X the right to manufacture and sell the products. X provides Y with copies of its licence agreements evidencing X's right to use the trademarks and to grant a security right in the trademarked inventory, as well as its obligations to the trademark owners. Y extends credit to X based on the value of the inventory. In this case, a security right in the inventory of finished jeans does not automatically extend to the trademark used, unless otherwise agreed by the parties (art. 17). Thus, if Y wishes to take a security right in the trademark licence, it has to be described in the security agreement as part of the collateral. (for additional examples, see Intellectual Property Supplement, paras. 35–45).

[*Note to the Working Group: The Working Group may wish to note that financing techniques described in Section B most often involve borrowers that are SMEs but many can be effectively used for financing to micro-businesses. Furthermore, the Working Group may wish consider the extent to which the draft Practice Guide should include a reference to value chain arrangements or supply chain financing arrangements which involve a number of different types of transactions mentioned above.*]

C. Due diligence — a key preliminary step for secured financing

1. Introduction

129. As indicated (see para. 8 above), this Practice Guide is not intended to be a primer on lending in general. It assumes that the readers are well-versed in the principles of extending unsecured loans and the due diligence that prudent lenders typically would conduct with respect to such unsecured transactions. However, when it is contemplated that a proposed loan will be secured by a movable asset, additional due diligence is required.

130. Much of the diligence recommended will be related to the borrower and other grantors of security rights. However, a larger percentage of the diligence recommended will be asset-specific. The diligence required when the collateral consists of receivables is very different than the diligence required when the collateral is inventory, equipment or intellectual property. Each category of asset presents unique issues, and the lenders and other credit providers that are most successful in secured lending are those who become expert in the collateral in which they take security rights.

131. It is also important to recognize that diligence in secured transactions is not merely something to be done at the outset of the transaction. Rather, it is a continuous process that must be conducted, at least to a certain extent, during the entire life of

the financing arrangement. For example, in a revolving receivables and inventory financing arrangement (see paras. 107–110 above), periodic evaluations of the receivables and inventory need to be conducted to verify that the information being provided by the borrower, as well as the lender's initial assumptions as to the valuation of collateral, remain accurate.

132. Diligence is not limited to the borrowers, guarantors and the collateral. Legal diligence is also required to determine if there are any applicable laws or regulations that prevent or restrict the providing of credit to those loan parties or limit the creation, priority or enforcement of a security right in particular assets (more generally, see Chap. I.E).

133. A lender often will begin the due diligence process by sending the borrower a diligence checklist or certificate to be completed by the borrower. This certificate provides essential information upon which the lender may base its due diligence process. An example of a diligence certificate (the "Sample Certificate") is provided in Annex II.

134. It is important to remember that diligence should never be conducted in a rote, obligatory fashion. It should be seen as a vital tool, enabling the lender to uncover, and address, the risks inherent in the transaction under consideration. It is also important to recognize that collateral is intended to enhance the likelihood that the lender will be able to recover its loan in the event of default; it is not intended to render the basic principles of extending credit irrelevant, or to relieve lenders from the necessity of conducting due diligence on the borrower or any guarantors.

135. Lenders would typically engage third-party service providers to perform the initial and ongoing diligence required for borrowers and their assets. For example, they may use credit bureaus to assess the credit of the borrower or guarantors, field examiners to inspect and evaluate the borrower's premises, books and records, appraisers to evaluate categories of assets such as receivables, inventory, equipment and intellectual property, industry analysts to explore the strengths and weaknesses of the industry in which the borrower operates and collateral monitoring services to assess the collateral from time to time during the term of the financing arrangement.

The risks of over-collateralisation

136. Under the laws of some States, lenders may be penalized if they take too much collateral for a given loan (referred to generally as "over-collateralisation", see Secured Transactions Guide, Chap. II, paras. 68–69). Under such circumstances, the lender may be obliged to release certain excess collateral to enable the borrower to use that collateral to obtain additional credit. Where over-collateralisation is more extreme, the enforceability of the lender's security rights may be jeopardized.

137. There is a relationship between over-collateralisation and due diligence. Diligence is costly (though the cost if often passed on to the borrower) and time-consuming. As a result, it can be far more convenient for a lender to take a security right in all of the borrower's assets rather than conduct diligence on certain assets that might persuade the lender to limit its security right to those assets. The lack of diligence might also cause the lender to focus less on the creditworthiness of the borrower and guarantors, relying instead on a security interest over all assets. This is particularly a danger for micro-businesses, which often lack the bargaining power to convince the lender to engage in due diligence.

138. Thus, although the availability of a security right in all of grantor's assets can be a great benefit to lenders and grantors alike, it also has dangers if it is not used responsibly. Its use should be confined to situations in which the lender, after conducting full diligence on the loan parties and their assets, believes that such a security right is essential to the credit transaction at hand, and should not be used as an excuse for failing to conduct proper diligence.

2. Due diligence on the borrower and other grantors

139. As noted above, much of the due diligence required for secured transactions pertains to the borrower and other grantors of security rights. Much of that diligence overlaps with the diligence conducted by a lender in connection with the granting of an unsecured loan. But there are differences as will be discussed below.

140. Section 1 of the Sample Certificate (contained in Annex II) is designed to elicit general information relating to the borrower, including the name of the company as it appears on its current organizational documents. This is not only relevant for the preparation of loan documents, but is critical to assure that searches of the Registry and notices to be registered reflect the correct name of the borrower. The lender must examine a copy of the organizational documents to verify the accuracy of the company's name. Sections 1(g) to (i) are designed to determine whether there are other names that must be searched to reveal any potential conflicting security rights in assets that are to serve as collateral. In conducting searches, prospective lenders are urged to err on the side of conducting searches under more rather than fewer names, in order to minimize the risk that a potential competing claim might remain undiscovered.

141. Section 4 of the Sample Certificate requests copies of material contracts that may be relevant. These include contracts such as loan agreements and guarantees, contracts that evidence other financial obligations, mortgages and other security documents, leases and agreements relating to changes in the company's corporate structure.

142. Section 6 of the Sample Certificate requests information as to litigation, both pending and potential, to which the company is a party, either as a defendant or plaintiff. An analysis of these claims can yield valuable information as to potential financial risks to which the company may be exposed, as well as how the company conducts its business. A lender may also wish to make further inquiries with the bankruptcy and insolvency officials to ensure that insolvency proceedings have not been commenced.

143. Section 7 of the Sample Certificate enquires as to transactions that the company has with its affiliate companies or affiliated individuals. It is important to verify that such transactions are conducted on an arms-length basis, and do not represent a potential source of self-dealing by the company.

144. Section 8 of the Sample Certificate requests information concerning outstanding tax assessments or proceedings against the company. This request is designed to determine whether the company is current in the payment of taxes, and also to identify potential tax liens or other priority claims in favour of taxing authorities that may affect the lender's collateral. In many States, certain claims are given priority even over prior-registered security rights without the need for registration (art. 36). Examples of common preferential claims are claims by the government or a government agency for unpaid taxes and other assessments and claims by employees for unpaid wages and other benefits. The lender should determine what preferential claims may exist against the borrower.

145. Section 11 of the Sample Certificate requests the identity of the company's officers, directors and managers, in part to enable the lender to conduct background checks on these individuals.

146. Section 12 of the Sample Certificate is designed to elicit miscellaneous information as to indebtedness to be paid out of the proceeds of the loan under consideration, the existence of any third-party consents that may be necessary in connection with the proposed loan, the extent to which the company's business is regulated, and whether the company is non-compliance with applicable laws or regulations.

[*Note to the Working Group: The Working Group may wish to consider whether the information above relating to the Sample Certificate should be retained in this part of the Practice Guide or merged as annotations to the Sample Certificate in the Annex.*]

3. Due diligence on the collateral

147. As noted above, much of the diligence for a secured loan relates to the collateral. This diligence covers matters such as:

- Identifying all of the grantor's assets
- Verifying that the borrower/grantor owns or has rights in the assets
- Ascertaining whether any third parties have conflicting security rights in, or other claims with respect to, the assets
- Verifying the existence of the assets
- Determining the value of the assets
- Determining whether the assets are adequately insured and
- Determining the location of the assets.

Identifying the grantor's assets

148. In many cases, the proposed collateral is readily identifiable. However, when the loan is designed to provide general working capital for the borrower's business, it may be secured by substantially all of the borrower's assets. In this case, it is important for the lender to understand what the borrower's assets are, in order to determine how to obtain an enforceable security right in each asset. Section 3 of the Sample Certificate is designed to elicit this information.

Verifying the grantor's ownership or other rights in the collateral

149. In order for a security right to be created, the grantor must have rights in the asset or the power to encumber it. Thus, it is important for a prospective lender to verify that the grantor meets this requirement with respect to each asset to be included in the collateral.

150. The Registry does not help with this aspect of diligence. Unlike certain specialized registries relating to certain types of assets (such as intellectual property, aircraft or ships), the Registry only contains information as to security rights in movable assets and offer no evidence as to the ownership of the assets. Thus, lenders need to rely on other sources.

151. The method used by lenders to verify the ownership of an asset will vary depending on the type of asset. In the case of receivables, the lender may examine the documents creating the receivable, such as the purchase order from the customer and the invoice to the customer. In the case of inventory or equipment, lenders can examine the purchase orders issued by the borrower to the suppliers of these assets as well as the invoices from the suppliers. In the case of a bank account, lenders can review the deposit agreement with the depositary bank, as well as bank statements. Many State have intellectual property registries from which it is possible to determine that the borrower is in the chain of title to the intellectual property in question. Otherwise, the lender may examine documents evidencing the borrower's rights to the intellectual property, such as license agreements and patent grants.

Ascertaining the existence of conflicting security rights in, or other claims with respect to, the assets

152. Lenders can easily search the Registry to determine whether any third party claims a security right in the proposed collateral. Thus, it is essential that lenders conduct a search of the Registry with respect to each prospective grantor at the outset of the diligence process.

153. A very useful technique used by lenders is to conduct two separate searches. One at the commencement of the diligence process, and the other after the registration to ensure that the notice is on record and that its priority is preserved. Because the Law allows for advance registration (see paras. 39–40 above), a lender conducting this second search can disburse funds without worrying that third parties will obtain a higher-ranking security right during the period from the date of registration and the disbursement of funds.

154. Where the lender identifies the existence of competing security rights or other rights in the assets, various means can be used to address the problem. In some cases, the obligation evidenced by a competing right may have been paid in full but the related notice simply not cancelled. In such circumstances, the third party can be contacted and asked to register a cancellation notice. If the registered notice is overly broad and describing assets that were not covered by the underlying security agreement, it may be possible to request an amendment notice, releasing the excess assets (see paras. 223–227 below). Where a search reveals the existence of a tax lien, it may be possible to obtain a subordination of the tax lien to the proposed new financing, which tax authorities in some States may be willing to do so as to preserve the borrower as a going concern, or to require that the delinquent taxes be paid out of the proceeds of the new financing. Finally, it may be the case that the search reveals a secured obligation that is to be repaid out of the proceeds of the new loan. In that case, the new lender can assure itself that its loan proceeds will be used for that purpose by obtaining a "pay-off" letter from the existing creditor stating the amount owing and disbursing the required amount directly to that creditor.

155. Under the Law, a buyer of an asset that is not sold in the ordinary course of the seller's business generally acquires the asset subject to any security right encumbering that asset granted by the seller (art. 34). It follows that a prospective lender should make inquiries to determine whether the potential grantor was the original owner of the collateral or acquired it from a previous owner. In the latter case, the secured creditor should conduct an additional search using the name of the prior owner as the search criterion to avoid the risk of a subsequent priority dispute with a secured creditor of a prior owner (see art. 26 of the Registry Provisions).

156. Under the Law, a security right in tangible collateral may be made effective against third parties also by possession (art. 18, see paras. 83–84 above), and priority between security rights made effective by registration and possession is determined by the order in which these steps were taken (art. 29). Consequently, even if a search of the Registry does not disclose any prior-registered security rights, a lender should verify that the grantor is in physical possession of the collateral and remains in possession when the lender registers a notice of its security right.

157. If a search of the Registry discloses that a prior notice has been registered, a lender will generally wish to obtain the agreement of the secured creditor identified in that notice to subordinate its priority before proceeding further with the transaction. A subordination agreement should be obtained even if the grantor has not in fact entered into a security agreement with that secured creditor. This is necessary because the lender (thus, a prospective secured creditor) will generally be subordinated, under the first-to-register priority rule, if the grantor were to later grant a security right in the relevant assets to the prior-registered secured creditor (art. 29).

Verifying the existence of the assets

158. Although it seems obvious that the lender must verify the existence of the proposed collateral, it is also the case that some of the greatest frauds perpetrated by borrowers against lenders have arisen where the assets did not exist.

159. There are many ways to verify the existence of assets. In the case of receivables, the lender may contact the debtors on the receivables to verify that the goods or services covered by the receivables were in fact received by the customer and that the customer acknowledges that it owes the full amount of the receivable to the borrower. The existence of inventory and equipment can be verified by a physical inspection by

the lender. An examination of the documents on file in an intellectual property registry can verify the existence of intellectual property rights. This type of diligence and monitoring should not be confined to the outset of the loan transactions but should be conducted periodically throughout the term of the loan.

Determining the value of the assets

160. An essential element of secured lending is that the lender has a strong understanding of the value of its collateral. However, the manner in which value is determined will vary greatly depending upon the type of asset involved.

161. In the case of a revolving receivables and inventory credit facility (see paras. 107–110 above), the lender typically will only make loans against a borrowing base comprised of receivables and inventory that are deemed to be "eligible" because they meet certain criteria. For example, the eligibility criteria with respect to receivables may relate to (i) the payment history of the debtors on the receivables, (ii) whether the receivables owing by a given debtor represent an uncomfortably high percentage of all of the borrower's receivables and (iii) the creditworthiness of the debtors of the receivables. The eligibility criteria relating to inventory may relate to their state in the borrower's manufacturing process (i.e. raw materials and finished goods are typically more valuable because they are readily marketable than to work-in-process which may not be saleable and therefore may have little or no value).

Determining whether the assets are adequately insured

162. In the event of loss or destruction of the collateral, the proceeds of insurance covering those assets serve as the substitute for the collateral. Thus, it is essential that the lender ensures that tangible movable collateral is adequately insured against loss or destruction by a reputable insurance company with amounts that accurately reflect the value of such collateral, and that the insurance proceeds are payable by the insurer directly to the lender via a loss payable clause.

163. In the case of receivables, it is increasingly common for lenders to require that the borrower obtain trade credit insurance insuring against the insolvency of the debtors of the receivables. The subject of trade credit insurance is quite complex, and lenders must not assume that, simply because the borrower maintains trade credit insurance, the lender will be protected against the risk of insolvency of the debtors of the receivables. Among other things, trade credit insurance policies typically contain elaborate reporting requirements, as well as a credit limit for each debtor and for each State in which debtors are located. The failure of the borrower to comply with these requirements could result in loss or reduction of coverage. Moreover, trade credit insurance is never a substitute for an enforceable security right in the receivables covered by the insurance; rather, it should be viewed as a supplement to the security right.

Determining the location of the collateral

164. Section 2 of the Sample Certificate requests information as to the place of central administration of the borrower as well as the locations where it stores any inventory or equipment.

165. When a company operates on a leased premises, lenders often request that the landlord sign a short agreement under which the landlord agrees, among other things, to waive any claim, under applicable law or the lease agreement, to the inventory, equipment or other property of the company located on the premises and to provide the lender with access to the premises in the event of the company's default under the loan documents. This would allow the lender to remove the asset or to conduct a sale (see Section G below). The willingness of the landlord to enter into such an agreement may differ depending on the jurisdiction; in some States, it may be customary for landlords to do so, while in others it is not.

166. When the company has inventory or equipment at third-party processors or warehouses, the lender should consider the advisability of requesting that the processor or warehouse enter into a separate agreement, often called a "collateral access agreement", under which the third-party agrees to provide the lender with access to the inventory or equipment upon the lender's demand. Often, such an agreement will provide for the payment of the fees owing to the processor or warehouse (which, under the laws of some States, could be a preferential claim on the assets in the possession of the processor or warehouse).

167. Section 3(b) of the Sample Certificate requests information as the borrower's bank accounts. In the case of bank accounts that are to be included in the collateral, the lender must ascertain the names and addresses of the depository banks and the relevant account information.

D. Searching the registry

1. Why and when to search?

168. Under the Law, priority of a security right is usually determined by the order in which the respective notice is registered in the Registry. It follows that once the essential elements of the security agreement has been agreed, a prospective secured creditor (as well as buyers, the grantor's judgment creditors or insolvency representative) should conduct a search of the Registry to determine if another creditor has already registered a security right in the prospective collateral. A second search should be conducted immediately after the registration to verify that no intervening registrations have been made by a competing secured creditor.

169. If its security right covers grantor's future assets, the secured creditor should generally conduct a new search before extending credit based on new assets acquired by the grantor. This is a necessary precaution because a subsequent lender or seller who advances credit to finance grantor's acquisition of the encumbered asset generally has priority over prior registered secured creditors (see paras. 100–106).

2. How to search?

What is the search criterion?

170. Searches of the Registry are to be conducted using the identifier of the grantor, in most cases, its name (arts. 22(a) of the Registry Provisions). As highlighted a number of times, the grantor is usually the person who owes the obligation but may also be a third person (see paras. 17 and 73 above). In that case, the search should be conducted using the name of the grantor and not the name of the debtor. That said, a prudent potential secured creditor will often conduct an additional search against the name of the debtor (including a guarantor of the secured debt) as part of its overall assessment of the debtor's creditworthiness.

How to determine the grantor's name?

171. Searchers are responsible for using the accurate name of the grantor in conducting searches as set out in the Law (art. 9 of the Registry Provisions). Secured creditors must refer such rules to ensure that the search result is reliable. Thus, a prospective lender, before conducting its search, should obtain the relevant official document from individual grantors or conduct searches of the relevant business or corporate records if the grantor is a business entity.

Exact match vs. close match registry systems

172. In some States, the Registry may seek to assist searchers by providing search results that disclose notices of security rights in which the name of the grantor closely matches the name entered by the searcher (option B in art. 23 of the Registry Provisions). In such case, searchers may wish to verify whether those disclosed

notices are relevant to the transaction. In any case, searches according to the accurate name of the grantor is necessary to ensure a reliable search result.

What if the grantor recently changed its name?

173. Where the grantor changes its name after the registration of a notice, the secured creditor would likely register an amendment notice within the brief grace period to reflect the new name of the grantor (art. 25 of the Registry Provisions). Otherwise, its security right will be subordinate to a subsequent secured creditor who registers its security right using the grantor's new name. Thus, a prospective lender should verify that the name of the grantor has not recently changed. If a change of name has occurred and the grace period has not yet expired, the lender should conduct an additional search using the prior name of the grantor to check if there are any competing security rights. A change of name of businesses can generally be determined by searching corporate or business records.

3. Searches in other registries

174. The Registry is the appropriate venue for registering and searching notices relating to security rights in most types of movable assets. However, security rights in some categories of assets may (or may also) be registered in other registries (art. 1(3)(e)). If the assets to be encumbered are those subject to a different registration regime but still fall within the scope of the Law, a prospective secured creditor will need to conduct a search of all relevant registries. [*Note to the Working Group: The Working Group may wish to consider whether the draft Practice Guide should include a list of such registries, which may differ depending on the jurisdiction.*]

175. If the collateral or the potential grantor is not located within the enacting State, a prospective secured creditor may need to conduct a search of the registry in other States (see Section J).

E. Preparing the security agreement (arts. 6(3) and 9)

176. The term "security agreement" designates the agreement under which a security right is created (art. 2(jj)). As the Law adopts a functional approach to the concept of security right (see Chapter I.B.3), the term security agreement includes not only an agreement creating a security right in assets owned by the grantor but also a contract of sale on retention-of-title terms or a financial lease. In addition, as the Law generally subjects an outright transfer of receivables to the same rules or those applicable to a security right, the term security agreement also includes an agreement whereby a person sells or otherwise dispose of receivables.

177. As discussed in Section A, a security agreement must be in writing (art. 6(3)). It may be oral if the secured creditor is in possession of the encumbered asset (art. 6(4)). However, in the latter case, parties will usually want to put their agreement in writing to avoid a dispute as to the exact content of that agreement.

178. Very few requirements are prescribed by the Law for a security agreement to create a valid security right (art. 6(3)). The security agreement must:

- Identify the parties (the secured creditor and the grantor)
- Describe the secured obligation and
- Describe the encumbered assets.

179. The description of the secured obligation and of the encumbered assets must be made "in a manner that reasonably allows for their identification" (art. 9(1)). The Law permits the creation of a security right not only in assets specifically described (for example, a specific car or truck) but also in assets of a generic category (for example, described as all of the inventory of the grantor). It is also possible for a grantor to grant a security right in "all of the grantor's movable assets" and a description in that manner would usually be sufficient (art. 9(2)). The encumbered assets may consist of

existing assets or assets to be acquired in the future by the grantor or both. Where the security right secures a line of credit made available by a bank to the grantor for the purposes of financing the business of the grantor, it is typical that the collateral will consist of all present and future movable assets of the grantor.

180. Under the Law, a security right may secure an obligation (present or future) by specifically identifying it or by stating all obligations "owed to the secured creditor at any time" (art. 9 (3)). In the latter case, no further description of the secured obligations is required (the description necessarily identifies the secured obligations because they consist of all present and future obligations owing to the secured creditor).

181. The enacting State may require that the security agreement indicate the maximum amount for which the security right may be enforced (art. 6(3)(d)), if it determines that such an indication would be helpful to facilitate secured lending by subsequent creditors. In that case, potential lenders will be able to ascertain whether the encumbered asset would still have some residual value for them after satisfaction of the claim of a prior-registered secured creditor through a search of the Registry (art. 8(e) of the Registry Provisions).

182. A security agreement will be a very short document (one page) if it includes only the basic requirements of the Law. However, the parties will usually add other provisions dealing with their rights and obligations (including on the monitoring of the encumbered assets and the enforcement powers of the secured creditor upon the occurrence of a default). Lenders would generally prepare the basic template for the security agreement.

183. With respect to the events which may trigger a default, they may be listed in the security agreement itself or the security agreement may refer to another agreement evidencing the secured obligations in which the events of default will be set out. If the agreement creating the security right is also the agreement whereby the secured obligations arise (e.g. a sale with a retention-of-title clause or a financial lease), the events of default will be found in that agreement. Where the security right is granted to secure obligations incurred under another agreement (e.g. a credit agreement for a line of credit or a specific loan), it is sufficient to refer to the credit agreement for the description of events of default. Of course, even where the secured obligations consist of advances under a line of credit or a specific loan, for sake of simplicity, the parties may wish to insert in one single document provisions relating to the credit facility and the creation of the security right.

184. Events of default in an agreement that constitutes both a credit agreement and a security agreement will typically include the following:

- The failure by the grantor to pay when due any amount owing under the secured obligations
- The failure by the grantor to make a payment to another creditor in respect of a monetary obligation that exceeds a certain threshold
- The occurrence of the insolvency of the grantor (with "insolvency" being often defined in detail) or any the encumbered assets being the subject of a seizure or enforcement measures or proceedings by a third party
- Any representation made by the grantor in the agreement or any document delivered to the secured creditor pursuant to the agreement being false or misleading in any material respect and
- Any non-performance in any material respect by the grantor of any of its obligations under the agreement.

185. Where the grantor is not the debtor of the secured obligations, the above events will be drafted to include the debtor whenever applicable. As well, it is usual to provide that certain of these events will constitute an event of default only after the expiry of a grace period.

186. The Law recognizes the principle of party autonomy on the provisions of the security agreement relating to the contractual rights and obligations of the parties, including on what constitutes default (art. 2(j), 3, 52 and 84, see paras. 16 and 30 above). Other laws of the enacting State may however limit the scope of party autonomy (e.g., consumer protection laws or a provision of the law of obligations stating that a default must be material to give rise to acceleration of a term loan).

187. A sample security agreement giving effect to the above-mentioned aspects is contained in Annex I.

F. Registration of a notice in the Registry

[*Note to the Working Group: The Working Group may wish to consider whether the draft Practice Guide should contain a separate section addressing steps that usually needs to take place before closing a secured finance transaction or before disbursement of funds (for example, ensuring that the grantor has executed all relevant documents). The section below focuses on registration of a notice as part of that process.*]

1. How and where to register and who should register?

188. The Law and the Registry Provisions contemplate an efficient, straightforward registration process. To register a notice with respect to a security right in the Registry, all that is needed is a notice giving some basic information (identifying the grantor and the secured creditor and describing the encumbered assets) to be submitted to the Registry (art. 8 of the Registry Provisions). In certain States, additional information may be required, such as the period of effectiveness of the notice and the maximum amount for which the security right can be enforced. Submission of this information is likely to be done online, which is registered and searchable as soon as the notice is registered.

189. Registration of a notice is not designed to protect the grantor and failure to do so would not affect the enforceability of the security right against the grantor. Thus, in practice, registration is usually done by the secured creditor to ensure that its security right is effective against third parties and has priority against other security rights.

190. A secured creditor is free to delegate the task of registering to a third party, for example, its lawyer or a firm that specializes such service (art. 5 of the Registry Provisions). However, the secured creditor is responsible for any errors or omission made by its authorized registrant. Thus, the secured creditor should make sure that it will have recourse against the third party in the event of error (for example, ensuring that the registrant is fully insured against liability for its errors). Even then, the secured creditor should promptly verify that the registration has been made correctly.

191. A registrant need only submit a completed notice to the Registry in the prescribed form, pay any prescribed fees (usually set on a cost-recovery basis), and identify itself in the prescribed manner (art. 5 of the Registry Provisions). The registration is effective as soon as the information in the notice submitted to the registry is publicly searchable (art. 13 of the Registry Provisions).

192. Registrants should refer to any specific guidelines provided by the State or the Registry. These guidelines will usually set out the requirements such as the mode of electronic transmission of information and how to set up and operate a user account (e.g., how to reset passwords for user accounts, what information is needed to set up a user account).

[*Note to the Working Group: A security right in some categories of movable assets may, however, be subject to a different registration regime. The Working Group may wish to consider to what extent this section should refer to the need to register in other registries and if so, which registries should be mentioned.*]

2. When to register an initial notice?

193. As discussed, registration can be made before the security agreement is concluded or the security right is created (see para. 39 above). A secured creditor should consider registering as soon as the general content of the financing arrangement has been agreed to benefit from the general priority against other secured creditors based on the order of registration.

194. Secured creditors are cautioned that advance registration does not necessarily provide protection against other types of competing claimants. For example, if the grantor sells an asset described in the notice before the security agreement is concluded, the security right will not be effective against the buyer. The same is true if insolvency proceedings are commenced by or against the grantor, or if a judgment creditor of the grantor obtains rights, before the agreement is concluded. Thus, secured creditors should not rely on advance registration as a reason to delay conclusion of the security agreement.

3. What information is to be included in an initial notice? (art. 8 of the Registry Provisions)

Name and address of the grantor and the secured creditor

195. The name and address of the grantor should be set out in the initial notice. If the debtor and the grantor are different, a notice that sets out the name of the debtor instead of the grantor would not be effective to make the security right effective against third parties. A secured creditor must ensure that it set outs the correct name of the grantor in the notice (art. 9 of the Registry Provisions). If a search using the correct name does not disclose a registered notice, the registration will be ineffective (art. 24 of the Registry Provisions).

196. The name and address of the secured creditor or its representative must also be set out in the initial notice. The name of a representative of the secured creditors would typically be used where the obligation is owed to a syndicate of multiple lenders. The correct name of the secured creditor or its representative is determined in accordance with the same rules that determine the correct name of the grantor (art. 10 of the Registry Provisions). However, the name of the secured creditor or its representative is not a search criterion. Thus, such errors do not render the registration ineffective unless it seriously misleads a reasonable searcher (art. 24(4) of the Registry Provisions). Nonetheless, secured creditors and its representatives should take care to enter its correct name and address. This will ensure that it receives any communications from third parties based on the information set out in the notice, for example, a notice of enforcement sent by a competing secured creditor (art. 78(4)) or a notice of intention to acquire an acquisition security right sent by a subsequent acquisition secured creditor (art. 38(2), option A).

Description of the encumbered assets

197. The initial notice must also contain a description of the encumbered assets. The inclusion of a description is necessary to enable searchers to determine which of the grantor's assets may be encumbered by a security right. A description is sufficient only if it reasonably allows identification of the collateral (art. 11 of the Registry Provisions).

198. The collateral does not necessarily have to be described specifically. A specific description is needed only if the encumbered asset is a specific item. Even then, it is sufficient if the description enables identification of the relevant asset. For example, a description such as "the grantor's automobile" would be sufficient if the grantor owned only one automobile but not necessarily so if the grantor owned more vehicles. In this case, a prudent registrant would provide additional descriptive details (for example, the model and model year of the automobile), since it is possible that the grantor might acquire additional automobiles in the future, making it difficult to identify which automobile is referred to in the notice.

199. The secured creditor should avoid describing the assets in a way that might require it to register an amendment notice due to subsequent events. For example, describing assets by their location (for example, “all equipment located at 123 Street, Capital City”) should generally be avoided unless the secured creditor is confident that the assets will be remain at that location for the duration of the financing relationship.

200. If the encumbered assets are a generic category of present and future assets, it is sufficient if the description refers to the generic category, for example, “all present and future receivables owing to the grantor” or “all of the grantor’s present and after acquired inventory.” If the security right is intended to cover “all the grantor’s present and future movable assets,” a description using those words is likewise sufficient.

201. The parties may contemplate entering into a series of security agreements over time. For example, an initial security agreement covering a specific item of equipment to secure a loan, and a subsequent security agreement covering all the grantor’s present and after acquired movable assets to secure a line of credit to be negotiated at a later point. In that case, a single notice is sufficient to cover the security rights created under multiple security agreements between the parties (art.3 of the Registry Provisions). Thus, in this example, the notice should describe the encumbered assets as “all present and after acquired assets of the grantor.” This will avoid the need to register a separate notice for each agreement. It will also ensure that security rights over assets covered by all later agreements generally have priority against subsequent competing secured creditors from the time the notice is registered.

Period of effectiveness of the registration

202. The Law may require that the initial notice indicate the period of effectiveness of the registration. In that case, the registrant should take into account the approach of the enacting State as the Model Law provides three options for determining the period of effectiveness of the registration (art. 14 of the Registry Provisions).

Statement of the maximum amount for which the security right may be enforced

203. The Law may also require that the initial notice indicate the maximum amount for which the security right may be enforced (in addition to it being set out in the security agreement, art. 6(3)(d), see para. 181 above). As noted, this is to enable a grantor to use the residual value of the asset to obtain financing from other creditors.

204. For example, suppose that the equipment owned by X has an estimated market value of $30,000. X creates a security right in that equipment in favour of Y to secure a loan (including interest and other anticipated charges) of $10,000. The security agreement and the relevant notice both indicate that the maximum value for which the security right can be enforced is $10,000. Y is secured as to the equipment only up to $10,000 and may be unsecured for any credit that it extends to X above that amount. Thus, a subsequent creditor will be willing to extend credit in the amount corresponding to the residual value of the equipment ($20,000).

205. This illustrates that a secured creditor must ensure that the maximum amount set out in the security agreement and in the registered notice is sufficient to cover all credit that it intends to be secured by the security right (present and future as well as any anticipated costs of enforcement in the event of default).

4. When should the secured creditor register an amendment notice?

206. A person identified in a registered notice as the secured creditor may modify the information in that notice at any time by submitting an amendment notice (art. 16(1) of the Registry Provisions). The following addresses the most common circumstances in which an amendment notice would be registered.

Correction of errors or omissions

207. The Registry is required to send a copy of the information in a registered notice to the secured creditor without delay after it is registered (art. 15(1) of the Registry Provisions). The secured creditor should immediately inspect the sufficiency and correctness of the information received and register an amendment notice to correct any errors or omissions.

Post-registration change in the name of the grantor

208. A grantor's name may change after a notice is registered, for example, because an individual grantor later applies to have her name legally changed or because a corporate grantor later amalgamates with another company. In those cases, the secured creditor should register an amendment notice disclosing the new name of the grantor during the grace period in order to preserve its priority (art. 25 of the Registry Provisions).

209. Suppose that the grace period for registering an amendment notice to disclose the new name was 60 days. On Day 1, Y registers an initial notice of its security right in X's equipment. On Day 20, the name of X is changed to X1. On Day 30, another creditor acquires a security right in the same equipment from X1 and registers a notice identifying X1 as the grantor. On Day 40, Y registers an amendment notice adding X1 as the grantor of its security right. Assuming that priority between Y and the new creditor is governed by the general first-to-register rule, Y would retain priority as against the new creditor.

210. A secured creditor can still register an amendment notice after the expiry of the prescribed grace period. However, the effectiveness and priority of its security right will not be preserved against buyers and secured creditors who acquired their rights after the grantor changed its name and before the amendment notice was registered. In general, secured creditors should take precautions to protect itself against the priority risk posed by a post-registration change in the grantor's name. For example, the secured creditor could periodically monitor whether a change of name or other change in status has occurred since the initial registration.

Post-registration changes in secured creditor information

211. There may be instance where the secured creditor information changes after the initial notice is registered. This may occur if the secured creditor changed its name or address or both. It may also occur when the initial secured creditor assigned its rights to a new secured creditor. While a change in the secured creditor information in the registered notice does not prejudice the effectiveness of the registration in any way, a secured creditor will generally wish to update the record to disclose any change. This can be done efficiently through a single global amendment notice, which would simultaneously update the relevant information in all notices registered by the secured creditor (art. 18 of the Registry Provisions). This will ensure that the secured creditor receives notices or other communications sent by third parties who relied on the name and address set out in the notice.

Addition of a description of new encumbered assets

212. A secured creditor may initially have registered a notice with regard to a security right in a specific item. If the secured creditor later agrees to extend a new loan to the grantor to be secured by a different item, the security right in that new asset would need to be made effective by registering an amendment notice (see para. 201 for the possible use of a single notice to cover multiple security rights).

213. The security right in the new asset will take effect against third parties only from the time of registration of the amendment notice. Instead, the secured creditor could register a new initial notice covering the new asset. However, the use of an amendment notice is more efficient. This is because the secured creditor will only

need to add the new asset to the description of the encumbered assets in its existing registered notice.

Addition of a description of proceeds of encumbered assets

214. As mentioned, a security right automatically extends to identifiable proceeds of the collateral (art. 10, see paras. 87–89 above). Suppose that X and Y concluded a security agreement with regard to X's equipment and Y registered a notice describing the equipment. Subsequently, X sells the equipment and is paid in cash. X then deposits the cash received from the sale of in its bank account. It later uses the funds in the bank account to purchase another equipment.

215. In these cases, the Law provides that Y's security right would extend to the money received, to the funds credited to X's bank account and the newly purchased equipment, as proceeds of the original collateral or proceeds of proceeds. However, this is subject to a number of requirements being met (for example, arts. 10, 19 and 47) and Y cannot be assured of its priority over competing claimants.

216. Therefore, a secured creditor should not passively rely on the proceeds of the collateral for protection. It should constantly monitor the collateral to ensure that it is in a position to take the necessary steps to preserve the third-party effectiveness and priority of its security right in the proceeds, including by registering an amendment notice adding the description of proceeds.

Addition of a buyer of an encumbered asset from the grantor as a new grantor

217. Registration of a notice generally protects the secured creditor against an unauthorized sale of the collateral by the grantor, unless the asset is sold in the ordinary course of the grantor's business (art. 34). The buyer of the collateral would automatically become an additional grantor. However, it would be most likely that only the name of the seller (original grantor) appears in the initial notice. Thus, if a prospective secured creditor who deals with the encumbered asset in the hands of the buyer searches the registry using the name of the buyer, the relevant notice would not be found.

218. The Model Registry Provisions provides three different options to address post-registration transfer of collateral (art. 26 of the Registry Provisions). Regardless of which option is adopted in the Law, a secured creditor should generally monitor the collateral to protect itself against unauthorized disposition of the collateral by the grantor. After all, it may be difficult to locate the asset once it has been disposed of.

[*Note to the Working Group: The Working Group may wish to consider providing the legal consequences under one of the options provided in article 26 of the Model Registry Provisions*.]

Extension of period of effectiveness of a registration

219. The financing relationship between the parties may extend beyond the period of effectiveness of the initial notice (see para. 202 above) and thus, a secured creditor can extend the period of effectiveness (art. 14 of the Registry Provisions). The secured creditor should ensure that it is alerted of any upcoming expiry of its registration with sufficient time to register an amendment notice.

5. What are the obligations of the secured creditor with regard to registration

220. The Law requires the grantor's written authorization for registration to be legally effective (art. 2(1) of the Registry Provisions). However, compliance with this requirement does not necessarily impede the efficiency of the registration process because:

- A secured creditor need not obtain the grantor's authorization before registration and the grantor's subsequent authorization operates retroactively to make the registration effective (art. 2(4) of the Registry Provisions)

- A written security agreement between the parties is automatically deemed to constitute authorization, regardless of whether the agreement was concluded before or after registration (art. 2(5) of the Registry Provisions) and
- The registry may not require the registrant to provide evidence that the grantor has authorized the registration (art. 2(6) of the Registry Provisions).

221. However, such operation may create difficulties for a grantor if a notice is registered but no security agreement is eventually concluded between the parties or if the concluded security agreement covers a narrower range of assets than those described in the registered notice.

Obligation to send a copy of a registered notice

222. To avoid such circumstances, the Registry is required to send the secured creditor a copy of the information in a registered notice without delay after the information is entered in the Registry. The secured creditor must then send that information to the grantor within the period specified in the Law after it receives the information. While failure to do so would not affect the effectiveness of the registration, the secured creditor may become liable to the grantor for a nominal amount specified in the Law and any actual loss or damage suffered by the grantor resulting from its failure (art. 15 of the Registry Provisions).

Registration of an amendment or cancellation notice

223. The secured creditor may be requested to register an amendment notice to correctly reflect the assets subject to the security right or those with regard to which the grantor has given authorization (art. 20(1) of the Registry Provisions).

224. The person identified in a registered notice as the grantor may also request the secured creditor to register a cancellation notice if:

- That person had not given authorization of the initial notice and has informed the secured creditor that it will not do so
- The previous authorization had been withdrawn with no security agreement being concluded or
- The security right has been extinguished [15] (art. 20(3) of the Registry Provisions).

225. Depending on the circumstances, the secured creditor may or may not be able to charge a fee for complying with such requests (art. 20(4) and (5) of the Registry Provisions).

226. In most cases, the secured creditor will voluntarily comply with its obligations to register an amendment or cancellation notice. If it fails to comply after the expiry of the short period specified in the Law, the grantor (or the person identified as grantor) may seek an order for the registration of an amendment or cancellation notice (art. 20(6) of the Registry Provisions). When such an order is issued, the Registry is obligated to register the notice without delay (art. 20(7) of the Registry Provisions).

227. Secured creditors should exercise great care when amending a registration to release certain assets and when cancelling a registration, particularly when the registered notice relates to multiple security rights created under different security agreements (see para. 201 above). A secured creditor should not cancel a registration simply because the obligations secured under one agreement are satisfied. Similarly, a cancellation notice should not be registered because one of the grantors was released.

[15] This means that all secured obligations have been discharged and the secured creditor is not committed to extend any further secured credit (art.12).

6. Registrations inadvertently amended or cancelled

228. Only the person identified as the secured creditor in the registered initial notice is authorized to register an amendment or cancellation notice relating to that notice. The only exception is where the initial secured creditor registered an amendment notice to identify a new secured creditor, for example, when it assigned its rights to another creditor. After registration of the amendment notice, only the person identified in the amendment notice as the new secured creditor is authorized to register an amendment or cancellation notice (art. 16(1) of the Registry Provisions).

229. Therefore, the registration of an amendment or cancellation notice requires the registrant to satisfy the secure access requirements specified by the Registry (art. 5(2) of the Registry Provisions). To guard against the risk of an inadvertent amendment or cancellation, secured creditors should institute procedures to preserve the confidentiality of their access credentials. A secured creditor would be responsible for an erroneous amendment or cancellation made by a person to whom it disclosed its access credentials to make registration on its behalf.

230. However, there may be instances where despite all precautions, an unauthorized person gains access to the secured creditor's access credentials and registers an amendment or cancellation notice. The effectiveness of such registration would depends on which option set out in article 21 of the Model Registry Provisions are chosen.

[*Note to Working Group: The Working Group may wish to consider whether the draft Practice Guide should include sample forms for authorizing registration of a notice (see para. 220 above) or requesting the registration of an amendment or cancellation notice (see paras. 223 and 224 above) in the Annex.*]

[*Note to Working Group: (1) The Working Group may wish to note that the current draft of the Practice Guide does not include a separate section on priority competitions, as they have been dealt with in different parts of the Practice Guide. The Working Group may wish to consider whether a separate section should be prepared to provide the various possible priority competitions and illustrate how the provisions of the Law would apply. Considering the variety of situations, it might be limited to the illustration to some key examples. (2) At its thirty-second session, the Working Group agreed that the draft Practice Guide should highlight the importance of monitoring collateral after the conclusion of the security agreement and disbursement of funds to preserve the priority of the security right (A/CN.9/932, paras. 82–84). Certain aspects have been dealt with in Sections C to F above, including how diligence would differ depending on the collateral and the need for continued monitoring, including of the grantor/debtor and the Registry. The Working Group may wish to consider whether a separate section is necessary in the Practice Guide to provide guidance on how monitoring is to be conducted and further noting that such monitoring should not result in undue interference with the grantor's conduct of business.*]

G. How to enforce a security right (arts. 72–83)

1. Notion of default and enforcement

231. Default is a defining moment in secured transactions. It is when the secured creditor will be able to assess the usefulness and effectiveness of its security right. Indeed, from the moment the debtor fails to perform the secured obligation, the creditor will seek to determine the market value of the collateral. In most cases, the creditor will have no intention of using or owning the asset. Thus, it is the market value (usually in the form of the selling price), that will allow the creditor to exercise its preferential right and recover payment of the sums due. This crucial phase is referred to as the enforcement phase.

232. In the Scenario, suppose that Y provided X a loan of $100,000, repayable in full after one year. To secure its claim, X grants a security right in its equipment to Y and Y registers a notice in the Registry. At the end of the loan term, X is unable to repay its outstanding obligation. Under such circumstances, Y will likely seek to exercise its security right on the proceeds and obtain repayment of the amount due by selling the equipment. While the sale of collateral is the traditional form of enforcing a security right, other means are provided for in the Law. For example, Y can also lease or license the equipment or propose to acquire it in total or partial satisfaction of the amount due to it.

233. The enforcement phase is also critical because it is the point at which priority competitions will need to be resolved, particularly when distributing the proceeds of the disposition of the collateral.

2. Terminating an enforcement process

234. Upon X's default, Y intends to enforce its security interest in the equipment. However, a friend of X is willing to advance money to repay the loan. Y plans to sell the equipment in a public sale to be held the following day and this has been advertised in local newspapers. In such circumstances, would X be able to terminate the enforcement process?

235. Enforcement is ordinarily a detrimental phase both for the grantor who will likely lose ownership to its collateral and for the secured creditor who, in most cases, would not obtain the full amount that it is owed, as the proceeds of the disposition will often be less than the secured obligation. Therefore, the Law allows any concerned person to terminate the enforcement process by paying what is owed to the secured creditor in full and by reimbursing reasonable enforcement costs that the creditor may have incurred (for example, the cost for advertising in the above example) (art. 75(1)).

236. However, termination is no longer possible once the collateral has been sold or disposed in the enforcement process, or once the secured creditor has entered into an agreement to sell or otherwise dispose of the encumbered asset, whichever may be earlier (art. 75(2)).

3. Taking over the enforcement process

237. Suppose that one month after obtaining the loan from Y, X obtained a new line of credit from Z for an amount of $50,000 repayable in three months. X grants a new security right to Z over the same equipment. Z registers a notice with respect to its security right in the Registry, which is later than Y's registration. On the expiry of the three-month period, X is not able to repay its loan. Y's claim is not yet due.

238. While X is in default with respect to its obligation to Z, it is not so with respect to its obligation to Y. Z's security right does not have priority over Y's security right. In such circumstance, the question arises how and under which conditions Z can commence enforcement without prejudice to the rights of Y, who might not be able to enforce its security right to the extent that X is not yet in default.

239. In order to protect its rights, a creditor whose security right has priority as against that of the enforcing secured creditor is entitled to take over the enforcement procedure at any time before it comes to an end, in other words, before the disposition or acquisition of the collateral (art. 76).

4. Obtaining possession of the collateral

240. Following X's default, Y wishes to enforce its security right in the equipment, which is still located in X's factory. Can Y freely take possession to realize its security right? Unless the secured creditor has chosen to make its security right effective against third parties by taking possession of the collateral, in the case of default, the creditor will usually need to take possession of the collateral held by the grantor for enforcement purposes. This phase is crucial.

241. A secured creditor is usually entitled to obtain possession of the collateral for enforcement purposes unless the asset is in the hands of a person with a superior right to possession (art. 77(1)). This may be the case if the asset is in the possession of a bona fide lessee or licensee of the encumbered asset (art. 34(3) or (5)) or a higher-ranking secured creditor (art. 77(4)).

242. After default, a grantor in possession of the collateral will need to surrender the asset to the secured creditor. However, the grantor may not be so cooperative. In that case, the secured creditor has two options. It can choose to initiate a judicial enforcement by applying to a court or other authority specified in the Law. This approach offers the advantage of being binding so that the seizure can take place despite any unjustified objection from the grantor in possession. However, it has the disadvantage of being cumbersome, often lengthy and costly.

243. For this reason, the secured creditor may have an interest, particularly when it appears that the grantor would not object, in obtaining possession of the collateral without applying to a court or other authority. However, this can only be done when certain conditions are satisfied (art. 77(2)). In essence, the Law put a limit on such extrajudicial possession process to balance the rights of the grantor and the creditor and to protect the public interest through a peaceful process.

244. Y must first obtain the written consent of X with regard to its extrajudicial possession, which is typically included in the security agreement between X and Y, or subsequently through a separate document. Y would also have to notify the grantor or any other person in possession of the collateral that X was in default and that it intends to take possession of the collateral. The Law may specify how much in advance such notice should be given (see Guide to Enactment, para. 441) as one of the measures to ensure that Y does not abuse its rights. However, in cases where the collateral is perishable or may decline in value rapidly, such a notice is not required (art. 77(3)). Finally and most importantly, the person in possession of the collateral should not object to the secured creditor taking possession. If the person objects, the creditor will have no choice but to initiate a judicial enforcement process.

245. The question arises as to whether, in the case a security right was granted in a generic category of assets, the creditor is entitled to seize all such assets in order to enforce its security right. In principle, this is possible as each asset under that category secures the entirety of the obligation. However, if the creditor knowingly and with intent takes possession of several assets when the value of one of the assets would be sufficient to secure the obligation, it may be contrary to the general standards of conduct provided in the Law.

5. Disposition of the collateral

246. Once the secured creditor is in possession of the collateral, it would seek to determine its value for the purposes of getting paid. In order to do so, the secured creditor can freely choose from different options provided under the Law. For example, after taking possession of the equipment, Y can sell or otherwise dispose of the equipment, lease it or acquire it in total or partial satisfaction of the secured obligation.

247. As a bank, Y would likely not have any intention to acquire the equipment for its use. From Y's perspective, the main objective would be to recover the loan to the extent possible through enforcement. Therefore, it is more likely that Y would want to sell the equipment as quickly as possible and at the highest possible price, to be reimbursed in full or in part based on the proceeds. The question arises as to the form of such sale or disposition.

248. One possibility is to go ahead with the sale by applying to a court or other authority specified in the Law. The method, manner, time, place and other aspects of the sale would be determined by the Law. While such public sale or court-supervised disposition may have its merits (in particular, for immovable property), it is often long, cumbersome and costly and may not be appropriate for sale of movable assets.

249. Therefore, another possibility is for Y to sell the collateral without applying to a court or other authority. In this case, the method, manner, time, place and other aspects of the sale (including whether to dispose of the collateral individually or altogether) would be determined by the secured creditor (art. 78(3)). While this gives much flexibility to the secured creditor, in order to do so, a number of conditions need to be satisfied (art. 78(4)–(8)). This is a procedural safeguard to ensure that any interested person is able to protect its own interests.

250. In essence, the secured creditor is required to notify its intention to proceed with the extrajudicial sale. It must notify the following persons (art. 78(4)):

- Grantor and the debtor
- Any person with a right in the collateral that had informed the secured creditor of that right in writing before the notice was sent to the grantor
- Any other secured creditor that has registered a competing security right in the collateral before the notice was sent to the grantor and
- Any other secured creditor that was in possession of the collateral when the enforcing secured creditor was in possession.

251. The secured creditor must notify the above-mentioned persons at least a certain period in advance of the sale (specified in the Law) and the notice should contain the following information:

- Description of the encumbered asset
- A statement of the amount owed to satisfy the secured obligation (including interest and reasonable cost of enforcement)
- A reminder that that persons with a right in the collateral (including the grantor and debtor) may terminate the sale by paying what is owed to the secured creditor in full as well as reasonable enforcement cost (see paras. 234–236 above) and
- After which date the collateral will be sold and
- Time, place and conditions of the sale.

252. The purpose of requiring such a notice is to enable the grantor or other competing claimants to verify that the sale will take place under commercially reasonable conditions, in accordance with the general standards of conduct (art. 4). If the sale does not take place under commercially reasonable terms, the secured creditor may be liable for damages caused by its breach. However, the grantor and other concerned parties cannot challenge the validity of the sale, unless it is proved that the buyer of the collateral was aware that the sale violated the rights of the grantor or those concerned.

6. Leasing or acquisition of the collateral

253. As indicated (see para. 232 above), Y had provided X a loan amounting to $100,000 and obtained a security right in the equipment, which was valued to be $120,000. Upon default, Y takes possession of the equipment. Unfortunately, the secondary market for this type of equipment is not active and it is not easy finding a buyer.

254. If it appears that the sale of the collateral will be problematic or will not yield the best price, Y may decide to use an alternative method. For example, Y may decide to lease the equipment and collect the rental payments, which will be deducted from the amount due (art. 78). X would retain ownership of the collateral but would be deprived of the right to use it in its business operation. The same procedural safeguards as outlined above (see paras. 250–251) applies to such leasing arrangements by the secured creditor.

255. Y may also offer to acquire the equipment as full or partial satisfaction of the secured obligation. In other words, the secured creditor would become the owner of the equipment whose value would be used to offset the amount of the secured obligation. The advantage of this method is that the secured creditor can enjoy all the rights and powers attached to ownership of the asset and subsequently dispose of it freely. The grantor may also request the secured creditor to choose this enforcement method (art. 80(6)). In any case, this method of enforcement is also subject to similar procedural safeguards (art. 80) as outlined below.

256. For the sake of transparency, the proposal by the secured creditor to acquire the collateral should be in writing and sent to the grantor, debtor and other persons with a right in the collateral (art. 80(2)). The proposal should also contain the following information (art. 80(3)):

- A statement of the amount required to satisfy the secured obligation (including interest and reasonable cost of enforcement) at the time of proposal
- A statement of the amount of the secured obligation that is proposed to be satisfied
- Description of the collateral
- A reminder that that persons with a right in the collateral (including the grantor and debtor) may terminate the sale by paying what is owed to the secured creditor in full as well as reasonable enforcement cost and
- After which date the secured creditor would acquire the collateral.

257. If there is no objection by any person entitled to receive the proposal within the specified period in the Law, the secured creditor would acquire the collateral (the conditions for acquisition is slightly different when it is in full satisfaction of the secured obligation and when it is in partial satisfaction, art. 80(4) and (5)). If an objection is raised, the secured creditor would have to select another method of enforcement.

7. Collection of payment

258. Suppose X also granted Y a security right over all receivables owed to it by one of its customers. Where the collateral is a receivable, a negotiable instrument or a right to payment of funds in a bank account, sale or disposition may not be an efficient method of enforcement. This is why, after default, the secured creditor is permitted to enforce its security right by collecting directly payment from the debtor of the receivable, obligor under the negotiable instrument or the deposit-taking institution (art. 82). In the example above, Y may collect payment from X's customer. However, it should be noted that the right of the secured creditor to collect payment is generally subject to the provisions in the Law on rights and obligations of third-party obligors (arts. 61–71).

259. While the Law generally applies to outright transfers of receivables (see paras. 23–24 above), the provisions on enforcement (arts. 72–81) are not applicable as there is no underlying secured obligation. In an outright transfer of a receivable, the transferee is entitled to collect the receivable at any time after payment becomes due (art. 83).

[*Note to the Working Group: The Working Group may wish to consider whether sample templates of payment instructions should be included in the Annex to the draft Practice Guide.*]

8. Distribution of proceeds

260. Suppose that after default, Y was able to sell the equipment for an amount of $120,000 to G. Y was owed $100,000 and had spent $2,000 on expenses related to the sale. Z has a lower-ranking security right in the equipment to secure a loan to X of $50,000 (see para. 237 above).

261. If the collateral was sold through a judicial disposition, the distribution of proceeds would be determined by the Law and in accordance with the provisions on priority. In the case above, as the equipment was sold by Y, Y is responsible for distributing the proceeds. Enforcement of a security right should not be a source of enrichment and thus a secured creditor must apply the proceeds to what it is owed after deducting the reasonable cost of enforcement. Afterwards, it must pay any surplus to any subordinate competing claimant that had notified the secured creditor of its claim and the claim amount. If any balance is remaining, it should remit the balance to the grantor (art. 79(2)).

262. Accordingly, Y would deduct $2,000 of cost and apply $100,000 as amount owed to it. This would generally extinguish the security right as full satisfaction of the secured obligation (unless there were outstanding commitments by Y to extend credit). Y would then disburse $18,000 to Z, whereas it is owed $50,000.

9. Rights of the buyer or other transferee of the collateral

263. In the example (para. 260 above), the buyer of the collateral (G) would take the asset free of any security right, except those that have priority as against the security right of the enforcing secured creditor (Y) (art. 81(3)). In other words, any other competing claimants whose rights have a lower priority than that of Y (for example, Z) can no longer exercise any right on the equipment that was sold. This provides a safeguard for buyers and other transferees who take part in the enforcement process.

264. However, suppose that Z had conducted the sale of the equipment to G at the price of $120,000. In that case, F would not take the asset free, as it would continue to be subject to the security right of Y. This suggests that it will be very rare to see a lower-ranking secured creditor take the initiative of selling collateral, as a buyer is unlikely to accept the risk of taking over an asset that is still subject to another security right.

[*Note to the Working Group: The Working Group may wish to consider what other aspects should be illustrated in this section, including practical problems that arise in the enforcement process. This may relate to limitations on enforcement found in other laws or abusive behaviour of relevant parties, for example, frequent change of name and/or address, and refusal to receive notices or proposals required under the Law.*]

H. What parties need to do during the transition from prior law to the Law (arts. 101–107)

265. The Law provides for fair and efficient transition rules from the prior law (the law formerly governing rights that fall within the scope of the Law). In general, the Law provides that the Law applies to all security rights, including prior security rights, as long as they fall within its scope. “Prior security rights” are rights created by an agreement before the Law entered into force, which are security rights within the meaning of this Law (art. 2(kk)) and to which the Law would have applied had it been in force when the right was created (art. 102).

266. As a general point, secured creditors should be aware that the third-party effectiveness and priority of prior security rights is preserved for a certain period of time after the Law enters into force. In order to extend the third-party effectiveness and priority beyond that period, the secured creditor must take the steps to make the security right effective against third parties in accordance with one of the methods provided for in the Law. This has the effect of making that security right effective against third parties from the time it was made effective against third parties under the prior law. The secured creditor could thus retain its priority.

267. For example, suppose that a financier had created security rights over a number of automobiles and had made its security right effective against third parties under

the prior law by noting it as the co-owner of the automobiles, both in the Motor Vehicles Registry records and registration documents issued by that registry. With the enactment of the Law, such notations are no longer recognized as a method of third-party effectiveness. Since most financing of automobiles is extended for a long period of time, the secured creditor should take the steps necessary to extend the third-party effectiveness and priority of the security right beyond the transitional period provided for in the Law. An easy way would be to register a notice in the Registry with regard to all such security rights.

I. Addressing cross-border transactions: a three-step analysis (arts. 84–100)

268. In a cross-border transaction (see Chap. I.F), it is crucial for the secured creditor to determine the law(s) that will apply to the third-party effectiveness and priority of its security right. In most cases, this will require a three-step analysis as described below. However, it should be cautioned that the analysis below is not necessarily comprehensive and only addresses third-party effectiveness and priority in the grantor's insolvency jurisdiction.

First Step

269. The creditor should identify the jurisdiction where it wants its security right to be recognized and to benefit from a priority ranking. The primary jurisdiction would be the jurisdiction where insolvency proceedings relating to the grantor are most likely to take place. This will typically be where grantor has its place of business and if the grantor has places of business in several jurisdictions, the jurisdiction in which the central administration of the grantor's business is exercised.[16]

Second Step

270. The creditor should then identify the law that the insolvency court will apply to determine if the security right was effective, was made effective against third parties and has priority. The conflict-of-laws provisions of the insolvency jurisdiction will indicate the substantive law that the insolvency court will apply to determine if the security right will be considered effective and enjoy priority in the insolvency jurisdiction.

271. If the insolvency jurisdiction has enacted the Model Law, articles 84 to 100 would be used to determine the law applicable. Yet, those provisions may provide that the applicable substantive law is the law of the insolvency jurisdiction or the law of another jurisdiction.

Third Step

272. The creditor should identify the steps to be taken under the applicable substantive law for its security right to be effective and to enjoy priority.

273. If the applicable substantive law is that of a State having enacted the Model Law, effectiveness against third-parties may be achieved by registration in the security rights registry established by the enacting State. In many circumstances, search of the registry will permit the secured creditor to know if its security right has priority.

274. If the applicable substantive law is that of a State which has not adopted the Model Law, registration might not be an available method for achieving effectiveness against third parties. For example, the substantive law of that State may instead

[16] The UNCITRAL Model Law on Cross-Border Insolvency and the EU Insolvency Regulation each use the concept of COMI (centre of main interests) to determine in which State main insolvency proceedings should be opened. The State where the insolvent debtor regularly conducts the administration of its interests is considered to be its COMI.

require notification of the security right to the debtors of the receivables for a security right to be made effective against third parties.

Examples

275. In the examples below, suppose that the State O has enacted the Model Law in its entirety.

Trade receivables

276. If a grantor located in State O granted a security right in trade receivables owed by customers in several other States, the insolvency jurisdiction would be State O (under the assumption that State O is where the central administration of the grantor' business is exercised). The substantive law that applies to third-party effectiveness and priority of the security right would be law of State O (where the grantor is located), in accordance with article 86 of the Law.

277. The third-party effectiveness requirements and priority rules under the Law would be applicable. Registration of a notice in the Registry would make the security right effective against third parties. The secured creditor will have priority if no other security right has been previously registered with respect to the receivables covered by the creditor's security right. The location of debtors of the receivables being in States other than State O is not relevant.

Inventory

278. If a grantor located in State O granted a security right in its inventory in a warehouse located in State P, the insolvency jurisdiction would be State O. The substantive law that applies to third-party effectiveness and priority of the security right would be law of State P (where the inventory is located), in accordance with article 85(1) of the Law (assuming that the inventory does not include tangible assets of a type ordinarily used in more than one State for which art. 85(3) would apply).

279. The third-party effectiveness requirements and priority rules would be determined under the applicable substantive law in State P. If the law of State P does not recognize non-possessory security rights, the creditor may not be unable to obtain a valid security right in the inventory.

Mobile goods

280. If a grantor located in State O granted a security right in a truck used to carry goods between States O and P, the insolvency jurisdiction, similar to above, would be State O. The substantive law that applies to third-party effectiveness and priority of the security right would be law of State P (where the grantor is located), in accordance with article 85(3) of the Law as the truck was ordinarily used in more than one State.

281. The third-party effectiveness requirements and priority rules under the Law would be applicable. In the example, even if the truck were used only in State P, the substantive law of State O would still apply to the third-party effectiveness and priority of the security right in the truck in State O.

III. The interaction between the Law and the prudential regulatory framework

[*Note to the Working Group: The following provides a brief outline of what the chapter on regulatory issues could look like in the Practice Guide. The Working Group may wish to consider whether the Practice Guide should further elaborate on a number of issues discussed. Furthermore, the Working Group may wish to consider how the material should be presented in the Practice Guide, taking into account the difference in audience and thus in style with the remaining chapters.*]

A. Introduction

282. Unlike the rest of the Practice Guide, this Chapter is addressed specifically to national financial authorities exercising prudential regulatory powers and supervisory functions (“regulatory authorities”) as well as those financial institutions that are subject to prudential regulations and supervision (“regulated financial institutions”). Typically, banks and other financial institutions that receive repayable funds, or deposits, from the public to extend loans would fall under this category.

283. The purpose of this Chapter is to assist enacting States as well as regulated financial institutions in fully benefiting from the Law and to emphasize the need for closer coordination between the Law and the national prudential regulatory framework. This should be understood in the broader context of interaction of the Law with various domestic laws required to ensure its proper operation as discussed in Chapter I. E. Core policy choices underlying the prudential regulatory framework, whether national or international, are not addressed in this Chapter.

284. Prudential regulation, a key component of a State’ prudential regulatory framework, is based on financial regulations that require financial institutions to control their exposure to various risks and to hold adequate capital. In other words, prudential regulations address the ability of regulated financial institutions to absorb losses, having in view both the soundness of the individual institutions as well as the stability of the financial system as a whole.

285. Prudential regulations prescribe certain measures to financial institutions, in particular to hold adequate capital as defined by capital requirements. Capital requirements or capital adequacy define the minimum level of capital (referred to as regulatory capital) regulated financial institutions are required to maintain at any point in time. Regulatory capital is typically composed of liquid instruments, such as shareholders’ equity, that are capable of absorbing unexpected losses.

286. As expected losses represent a cost related to the credit transaction, they are covered by financial institutions through a variety of techniques. Capital requirements may also address expected losses and, in particular, may contain specific requirements whereby financial institutions must set aside reserves, or allowances, against impaired, defaulted and uncollectible obligations. [*Note to the Working Group: The Working Group may wish to consider whether the Practice Guide should elaborate further on provisioning for expected losses.*]

287. Capital requirements are commonly expressed as a capital adequacy ratio, a percentage of the assets weighted to their risk. In other words, the amount of capital is not fixed, but is relative to both the overall business volume of the regulated financial institution and the risks associated with its business. In practice, for every financing transaction, such as the extension of a loan, regulated financial institutions calculate a capital charge, which represents a portion of regulatory capital and reflects how risky the transaction is. Loans that present a high level of risk are subject to higher capital charges than those considered less risky. For financial institutions, this means that the riskier the exposure, the higher the amount of regulatory capital required. National statutory or regulatory laws defining capital requirements not only determine the risk weights of different classes of assets but also provide for capital adequacy ratios and procedures to calculate capital charges.

288. International efforts have been made to ensure that prudential regulation of financial institutions is harmonized and applied consistently across jurisdictions through uniform supervisory practice. The Basel Committee on Banking Supervision (BCBS) is one of the organization entrusted with that task, among others, establishing internationally recognised standards on capital requirements that are contained in the Basel Capital Accords.

289. As mentioned previously, this Chapter aims at ensuring that regulated financial institutions benefit from the Law, while at the same time being compliant with the relevant prudential regulatory framework concerning capital requirements. In many

States, before the enactment of the Law and thus the secured transactions regime envisaged by the Model Law, there may not have been sufficient legal certainty for regulated financial institutions to take into account the value of movable assets when calculating regulatory capital. The Law coupled with the Registry provides the necessary legal certainty, predictability and transparency thus facilitating compliance with capital requirements. Through further coordination with prudential regulation, it would be possible for regulated financial institutions to take into account security rights in movable assets when determining capital charges. To this end, this Chapter focuses on aspects relevant for assessing credit risk exposures when obligations are secured by movable assets.

B. Key terminology

290. Terminology used by national regulatory authorities and regulated financial institutions may differ from those used in the Law. The following are some examples.

[*Note to the Working Group: The Working Group may wish to note that Chapter III refers to a number of terminology not used in the Model Law and thus may wish to consider whether they should also be included in the list below. The Working Group may also wish to consider whether the list below, if found appropriate, should be combined with the glossary found in Chapter I. D.*]

Collateralized transactions	One of the techniques that regulated financial institutions may adopt to mitigate credit risk. They encompass any consensual arrangement whereby the exposure to credit risk is covered, fully or partially, by a right in an encumbered asset (including a security right under the Law)
Credit risk mitigation	Various techniques, such as collateralised transactions, rights of set-off and guarantees, used by regulated financial institutions to reduce their exposure to credit risk. When specific requisites are met, the use of credit risk mitigation techniques could result in lower capital charges.
Eligible collateral	Assets that are encumbered by a security right and are recognised, under applicable capital requirements, to reduce capital charges
Eligible financial receivables	Receivables that are recognised, under applicable capital requirements, to reduce capital charges. They are typically short-term claims that arise from the sale of goods or provision of services, including debts owed by buyers, suppliers, governmental authorities, or other unaffiliated parties.
Physical collateral	Tangible movable assets such as machinery, raw materials and motor vehicles, with the exception of commodities and aircraft (which typically belong to different categories of exposures)

C. Enhancing coordination between the Law and prudential regulation

291. The primary objective of the Law is to increase access to credit at a reasonable cost, through the establishment of a modern secured transaction regime facilitating, among others, the creation and enforcement of security rights in movable assets. Under the Law, financial institutions may acquire a security right to reduce their exposure to credit risk, which should incentivise them to increase the availability of credit. The Law does so by covering a wide range of assets (for example, motor

vehicles and trade receivables, see para. 12 above) and permitting parties to tailor their arrangement to fit their needs and expectations (see para. 15 above).

292. To a certain extent, capital requirements, in pursuing prudential regulation, may discourage regulated financial institutions to extend credit base on security rights over movable assets. Although prudential regulation generally treats collateral favourably, capital requirements take a conservative approach towards certain movable assets that may not necessarily qualify as eligible collateral. This calls for coordination between secured transactions law and capital requirements, in the absence of which regulated financial institutions may simply treat transactions secured by movable assets as unsecured credit, limiting the economic benefits foreseen by the Law.

General prerequisites

293. In order for a collateralised transaction to be recognised as an eligible credit risk mitigation and thus result in lower capital charges, some essential requisites need to be met. In particular, following internationally recognised capital requirements, legal certainty over security rights and their efficient enforceability after default of the debtor are essential prerequisites.

294. With respect to collateralised transactions, financial institutions are usually required to demonstrate that the following two pre-conditions are met. First, a security right must have first priority aside from statutory and preferential claims. The Law, in Chapter V, provides a comprehensive and coherent set of priority rules (Chap. I.B.5). Therefore, it is possible for regulated financial institutions to clearly identify the priority of their security right. Second, a security right must be enforceable in a timely manner. The Law, in Chapter VII, provides rules to facilitate efficient and expeditious enforcement of a security right (including expeditious proceeding or relief as provided under art. 74, see generally Chap. II.G). In short, the Law provides a mechanism whereby regulated financial institutions could meet the general prerequisites enumerated in national and international capital requirements for the calculation of capital charges.

295. Financial institutions are also required to develop sound internal procedures, to control, monitor and report any risk associated with the collateral, including those that could potentially compromise the effectiveness of the credit risk mitigation. Moreover, they are usually required to establish internal procedures to ensure expeditious enforcement of security rights. To this end, it is important for financial institutions to become familiar with the relevant provisions of the Law, particularly on the steps necessary to enforce their security rights. They should also adopt policies to ensure that the priority of their security rights is not undermined, for instance, by the inadvertent lapse of the effectiveness of a registration of a notice.

296. If a collateralised transaction involves connections with more than one State and thus may be governed by foreign law, financial institutions would need to ensure that their security rights are adequately protected (mainly their priority and enforceability) under that law. The provisions in Chapter VIII (Conflict of laws) of the Law provide clarity on the applicable law to achieve the necessary certainty.

Capital requirements

297. There are various methodologies to assess credit risk and to calculate corresponding capital charges. Under the standard method (standardized approach), risk weights are set forth in national statutory or regulatory laws, which also set out encumbered assets that are eligible to reduce capital charges. Typically, and as provided in international standards, the list of eligible collateral includes only highly liquid assets, such as funds held in deposit accounts with the lending financial institution,[17] gold and intermediated securities.[18] Accordingly, movable assets that

[17] A different regulatory treatment might apply when the account is held by another financial institution.

[18] Security rights in intermediated securities are not covered by the Law (art. 1(3)(c)).

usually compose the borrowing base of businesses (such as receivables, inventory, agricultural products, and equipment) are not eligible collateral under the standard method. Therefore, they cannot be taken into account when capital charges for unexpected losses are calculated.

298. Capital requirements may allow for the use of other methodologies as well. Assets most commonly owned by businesses can only be considered as eligible collateral when regulated financial institutions have been authorised to use more sophisticated methodologies, often referred to as internal models. If authorised by regulatory authorities, financial institutions may deploy their own estimates to calculate risk exposures and, thus, determine capital charges. Financial institutions determine different risk components, such as the probability of default, losses expected upon default and the exposure if such a default occurs.

299. The authorisation process is generally set forth in national statutory or regulatory laws. In line with recognised international standards, authorisation requires a thorough supervisory examination of the risk-management practices of the financial institution in general as well as scrutiny of internal estimations and data used to calculate capital charges. Regulatory authorities may establish additional requisites to foster the soundness and the reliability of the models. Typically, regulatory authorities may authorise or reject a request for authorisation to use internal models for any class of exposures and may also withdraw any previous authorisation.

300. In order to incentivise inclusive and responsible lending secured by movable assets as envisaged by the Law, adoption of sophisticated methodologies based on accurate risk assessment is of primary importance. For many financial institutions operating in jurisdictions where movable assets are not eligible collateral under the standard model, adoption of internal models may provide the only option to measure the exact level of credit risk resulting from loans to businesses based on movable assets. While the Law provides the framework for the eventual recognition of movable assets as eligible collateral, regulated financial institutions need to be well versed in its application and meet the requirements for obtaining authorisation to use internal models. To this end, they are required to implement sound internal procedures to assess and manage credit risk and to gather sufficient date on collateralized transactions. Once the use of internal models has been authorized, financial institutions would need to further demonstrate that requirements for considering movable assets as eligible collateral are met. Typically, different requirements apply to physical collateral and receivables.

301. For physical collateral to be considered as eligible collateral, financial institutions need to demonstrate the existence of liquid markets to dispose of encumbered assets in a timely manner. Transparent and publicly available prices should also be available to allow for an accurate estimate of the value to be realised in case of default.

[*Note to the Working Group: Capital requirements typically provide for a series of requisites on the valuation of physical collateral. For instance, capital requirements often indicate that financial institutions need to establish examination procedures for internal and auditing purposes. It is usually required to determine the volatility of the value of the collateral in consideration of market trends and in relation to the deterioration or obsolescence of the collateral. In particular, international capital requirements may require that the loan agreement include a detailed description of the physical collateral and the right of the financial institution to examine and revalue the collateral whenever deemed necessary (see, for example, para. 296 of Basel III available at https://www.bis.org/bcbs/publ/d424.pdf). In case of inventories and equipment, periodic revaluation process must include physical inspection of the collateral. These aspects would need to be taken into account for proper coordination with the Law. The Working Group may wish to consider to what extent such aspects need to be reflected in the Practice Guide.*]

302. For receivables to be considered as eligible collateral, financial institutions are typically required to have the right to collect or transfer the receivables without any

consent of the debtor of the receivable. Such mechanisms are provided for in the Law with regard to collection and transfer of receivables (see for example, arts. 58, 59, 82 and 83). Furthermore, financial institutions are often required to establish lending policies determining which receivables may be included in the borrowing base and those that will not be taken into account when setting the amount of available credit.

[*Note to the Working Group: Similar to physical collateral, there may be other requirements relating primarily to the credit collection policies and risk assessment of the financial institutions. The Working Group may wish to consider to what extent the Practice Guide should elaborate on such requirements.]*

303. While coordination efforts between the Law and prudential regulation may result in reduced capital charges, that should not be the sole purpose of coordination. Rather, the purpose of such coordination is to promote sound risk management that is based on a thorough assessment of risks related to collateralized transactions rather than on speculative suspicion towards certain classes of assets.

304. In conclusion, the economic benefits of the Law may be enhanced when national prudential regulatory frameworks, in compliance with international standards, contemplate the possibility for regulated financial institutions to use methodologies based on internal models. With the adoption of internal models, financial institutions will be required to deploy sophisticated risk management tools scrutinised by regulatory authorities and will thus be acquiring expertise on prudent lending and on the legal framework established by the Law. The assessment of credit risk will be based on accurate data and its management will be conducted through reliable models measuring the effects of various classes of encumbered assets on expected and unexpected losses. The information gathered would be shared, for authorisation purposes, with regulatory authorities that, in turn, would acquire a better understanding of secured lending as provided in the Law. Furthermore, data on the timeframe to enforce security rights on various types of movable assets as well as the value recovered from the disposal of those assets may contribute to the development of new secondary markets or may inject further transparency into existing ones.

Annex I

Sample security agreement

SECURITY AGREEMENT

Between

MODERN TECHNOLOGIES INC., a corporation constituted under the Corporations Act of State Y, having its registered office at 111 Innovation Avenue, Springfield, State Y and its place of central administration at 222 Gold Avenue, Diamond City, State X, (the "**Grantor**")

And

BANK OF THE WEALTH, a bank constituted under the laws of Z, having a branch at 555 Bank Street, Diamond City, State Z (the "**Creditor**")

Recitals

A. The Creditor has agreed to make available to the Grantor revolving credit facilities pursuant to a credit agreement dated [30 April 2018].[19]

B. The execution of this agreement is a condition to the extension of credit by the Creditor to the Grantor under that credit agreement.

1. Definitions

In this agreement:

(a) "Credit Agreement" means the credit agreement referred to in Recital A, as same may be amended, supplemented or restated from time to time;

(b) "Encumbered Assets" has the meaning given to that term in Section 02.1 below;

(c) "Event of Default" means (i) any event that constitutes an "event of default" under the Credit Agreement, and (ii) any failure by the Grantor to comply with any of its obligations under this agreement;

(d) "Obligations" means all present and future obligations of the Grantor to the Creditor under or contemplated by the Credit Agreement and this agreement;

(e) Each of the following terms has the meaning given to it in the Law: "bank account", "control agreement", "debtor of the receivable", "equipment", "inventory", "proceeds" and "product".

2. Grant of the security right and secured obligations

2.1 Grant of the security right

The Grantor grants to the Creditor a security right in all of the Grantor's present and future movable assets (the "Encumbered Assets")[20] [within each of the following categories:

(a) Inventory;

(b) Receivables;

(c) Equipment;

(d) Funds credited to a bank account;[21]

(e) Documents of title[22] (whether negotiable or not), including without limitation bills of lading and warehouse receipts;

[19] The term "credit agreement" is used as a generic term to describe the agreement under which credit may be extended by the Creditor. Other terms may indeed be used (e.g. loan agreement or promissory note) depending on the nature of the credit transaction and/or local practices.

[20] The Law recognize that a security right may be granted in all present and future movable assets of the grantor (or of a generic category) and that the description of the encumbered assets in the security agreement may be made in the same manner (arts. 6, 8 and 9).

[21] The term, while not defined in the Law, are recognized as a distinct category of assets (see arts. 15, 25, 46, 69 and 97).

[22] The Law recognizes negotiable documents as a distinct category of tangible movable asset (see art. 2(ll)).

(f) Negotiable instruments,[23] including without limitation bills of exchange, cheques and promissory notes;

(g) Intellectual property and rights under licenses;

(h) To the extent not listed above, all proceeds and products of all of the foregoing.]

2.2 Secured Obligations

The security right hereby granted secures all Obligations.[24]

3. Representations and warranties[25]

The Grantor represents and warrants to the Creditor that:

3.1 Location of certain Encumbered Assets

(a) The inventory and the equipment of the Grantor are and will be held or used by the Grantor at all times in State X and State Y and, unless the Grantor notifies the Creditor of a change, at the addresses listed in the Annex to this agreement;

(b) The billing addresses of the debtors of the receivables owed or to be owed to the Grantor are and will be at all times in State X and State Y [, unless the Grantor notifies the Creditor of a change by a notice specifying the other State(s) in which debtors of these receivable have billing addressees];

(c) The bank accounts of the Grantor are and will be held at all times at branches of banks in State X and State Y, and, unless the Grantor notifies the Creditor of a change, at the addresses listed in the Annex to this agreement. The account agreements relating to these bank accounts are and will be governed by the law of the State in which the applicable branch is located and do not and will not refer to another law for matters relevant to this agreement.[26]

3.2 Location and name of the Grantor

(a) The registered office and the place of central administration of the Grantor are and will be located at all times in the States specified on the first page of this agreement;

(b) The Grantor's exact name and State of [constitution] are as specified on the first page of this agreement. The Grantor will not change its State of [constitution] without the prior written consent of the Creditor and will not change its name without giving to Creditor a 30 day prior notice of the change.

4.Authorizations relating to the Encumbered Assets

4.1 Registrations

The Grantor authorizes the Creditor to register any notice and take any other action necessary or useful to make the Creditor's security right effective against third parties.[27]

4.2 Inspection and copies

(a) The Creditor may inspect the Encumbered Assets and the documents or records evidencing same (and for such purposes enter into the Grantor's premises), upon giving prior reasonable notice to the Grantor;

(b) At the request of the Creditor, the Grantor will furnish to the Creditor copies of the invoices, contracts and other documents evidencing its receivables.

[23] The Law recognizes negotiable instruments as a distinct category of tangible movable asset (see art. 2(ll)).

[24] Article 9 of the Law recognizes that the secured obligations may be described by referring to the agreement under which they arise.

[25] This security agreement only includes representations on facts that permit a secured creditor to identify the State(s) whose law(s) will apply to the creation, effectiveness against third parties and priority of a security right. Among other things, the information contained in this Section will permit the secured creditor to determine where a registration needs to be made.

[26] This is to ensure the identification of the applicable law under article 97 of the Law.

[27] This authorization is required under article 2 of the Model Registry Provisions.

4.3 Dealings with Encumbered Assets

(a) Until the Creditor notifies the Grantor that an Event of Default has occurred, the Grantor may sell, lease or otherwise dispose of its inventory and documents of title, collect its receivables and negotiable instruments and dispose of worn-out or obsolete equipment, in each case, in the ordinary course of its business;

(b) The Grantor will not grant any security right in the Encumbered Assets and, except as permitted by paragraph (a), will not sell, lease or otherwise dispose of the Encumbered Assets;[28]

(c) The Creditor may at any time notify the debtors of the Grantor's receivables of the existence of its security right. However, a notification given prior to the occurrence of an Event of Default will authorize the debtors to make their payments to the Grantor until otherwise instructed by the Creditor following the occurrence of an Event of Default.[29]

5. Covenants relating to the Encumbered Assets

5.1 Movable assets

The Grantor undertakes that the Encumbered Assets will remain movable assets at all times and will not be attached to immovable property.

5.2 Effectiveness of the security right

The Grantor will take all actions and execute all documents as are reasonably required by the Creditor for the Creditor's security right to be at all times enforceable and effective and enjoy priority against third parties in all States where the Encumbered Assets may be located or where the security right may be enforced.

5.3 Bank accounts

The Grantor will take all steps required for the Creditor's security right to be made effective against parties through a control agreement with respect to all funds credited to a bank account held with a bank other than the Creditor.[30]

5.4 Reimbursement of expenses

The Grantor will reimburse the Creditor upon demand for all costs, fees and other expenses incurred by the Creditor in the exercise of its rights under this agreement (including without limitation in the enforcement of its security right), with interest at annual rate of **%.

6. Enforcement[31]

6.1 Rights after an Event of Default[32]

After the occurrence of an Event of Default and to the extent same is continuing:

(a) the Creditor may enforce its security right and exercise all rights of a secured creditor under the Model Law and any other applicable law;

(b) the Creditor may also, subject to any mandatory provision of applicable law;

(i) take possession, use, operate, administer and sell, lease or otherwise dispose of any of the Encumbered Assets, in each case, on terms and conditions it deems appropriate;

[28] This prohibition is a contractual obligation and is not binding upon third parties. For example, a third party who purchases an encumbered asset may acquire it free of the security right in certain circumstances (see art. 34).

[29] See art. 63(2).

[30] This method is provided in article 25(b) of the Model Law. If the bank accounts are with the Creditor, then the Creditor will benefit from automatic third-party effectiveness (see article 25(a)).

[31] Enforcement is dealt with in Chapter VII of the Model Law. Section 6 uses the term "rights", instead of remedies, because the latter term is not used in the Model Law.

[32] Under this Section, the secured creditor may take possession and sell encumbered assets without court intervention (arts. 77 and 78).

(ii) collect the Grantor's receivables and negotiable instruments, compromise or transact with the obligors of these receivables and instruments, and grant discharges to them; and

(iii) take all other actions necessary or useful for the purpose of realizing on the Encumbered Assets, including without limitation completing the manufacture of inventory and purchasing raw materials.

6.2 Access to the Grantor's premises

The Grantor grants to the Creditor the right to enter into and use the premises where the Encumbered Assets are located for the purposes of the exercise of the Creditor's enforcement rights.[33]

6.3 Manner of enforcement

The enforcement rights provided in this Section may be exercised on all of the Encumbered Assets taken as a whole or separately in respect of any part of them.

7. General Provisions

7.1 Additional and continuing security

The security right created by this agreement is in addition to (and not in substitution for) any other security held by the Creditor and is a continuing security that will subsist notwithstanding the payment from time to time, in whole or in part, of any of the Obligations.

7.2 Collections

Any sum collected by the Creditor from the Encumbered Assets prior to all the Obligations becoming due may be held by the Creditor as Encumbered Assets.

7.3 Other recourses

The exercise by the Creditor of any right will not preclude the Creditor from exercising any other right provided in this agreement or by law, and all the rights of the Creditor are cumulative and not alternative. The Creditor may enforce its security right without being required to exercise any recourse against any person liable for the payment of the Obligations or to realize on any other security.

7.4 Inconsistency with the Credit Agreement

In the event of any conflict or inconsistency between the provisions of this agreement and the provisions of the Credit Agreement, the provisions of the Credit Agreement will prevail.

8. Governing Law

This agreement will be governed by and construed in accordance with the laws of State X. The provisions of this agreement must also be interpreted in order to give effect to the intent of the parties that the Creditor's security right be valid and effective in all jurisdictions where the Encumbered Assets may be located and where the rights of the Creditor may have to be enforced.

9. Notices

Any notice by a party to the other must be in writing and given in accordance with the notice provisions of the Credit Agreement.

[33] This is a personal obligation of the Grantor and may not necessarily be enforceable against the owner of premises leased to the Grantor without the consent of the owner.

Counterparts and signatures

This agreement may be executed in any number of counterparts and by each party in separate counterparts and any full set of these separate counterparts will constitute an original copy of this agreement. Delivery of an executed counterpart of a signature page to this agreement by electronic mail will be as effective as delivery of a manually executed counterpart of this agreement.

SIGNED by the parties as of DD/MM/YYYY.

MODERN TECHNOLOGIES INC.	BANK OF THE WEALTH
____________________	____________________

Annex II

Sample diligence certificate[34]

To: ABC Bank

The undersigned, the [__________] of _________________ (the "Company") hereby represents and warrants to you as follows:

1. GENERAL INFORMATION RELATING TO THE COMPANY

(a) The name of the Company as it appears in its current organizational documents is: [__________];
(b) The tax identification number of the Company is: [ ];
(c) The jurisdiction of formation of the Company is: [__________];
(d) The organizational identification number of the Company is: [ ];
(e) The Company transacts business in the following jurisdictions (list jurisdictions other than jurisdiction of formation): [__________];
(f) The Company is duly qualified to transact business as a foreign entity in the following jurisdictions (list jurisdictions other than jurisdiction of formation): [__________];
(g) The following is a list of all other names (including fictitious names, trade names or similar names) currently used by the Company or used within the past five years: [ ];
(h) The following are the names of all entities which have been merged into the Company during the past five years: [ ];
(i) The following are the names and addresses of all entities from whom the Company has acquired any personal property in a transaction not in the ordinary course of business during the past five years, together with the date of such acquisition and the type of personal property acquired:

Name	Address	Date of Acquisition	Type of Property

(j) Attached are copies of all organizational documents of the Company, along with copies of any agreements, certificates or other instruments evidencing equity securities (other than common stock), including warrants, option agreements, partnership agreements, limited liability company agreements and similar instruments and agreements.

2. LOCATIONS OF THE COMPANY

(a) The place of central administration of the Company is presently located at the following address: [*List of Complete Street and Mailing Address*];
(b) The following are all of the locations (including third-party processors or warehouses) where the Company maintains or stores any inventory, equipment or other property: [*List of Complete Street and Mailing Address*].

3. SPECIAL TYPES OF COLLATERAL

(a) If the Company owns any of the following kinds of assets, please attach a schedule describing each such asset:

Registered copyrights or copyright applications	Yes ☐ No ☐
Unregistered copyrights	Yes ☐ No ☐
Registered patents and patent applications	Yes ☐ No ☐
Registered trademarks or trademark applications (including any service marks, collective marks and certification marks)	Yes ☐ No ☐
Licenses to use trademarks, patents and copyrights of others	Yes ☐ No ☐
Stocks, bonds or other securities	Yes ☐ No ☐
Promissory notes or other instruments evidencing indebtedness owing to the Company	Yes ☐ No ☐
Leases of equipment or security agreements naming the Company as the secured creditor	Yes ☐ No ☐
Motor Vehicles	Yes ☐ No ☐

[34] This form should be duly modified to request all of the same information for each co-borrower or guarantor of the loans.

(b) The following are all banks or savings institutions at which the Company maintains a deposit account, securities account or commodity account:

Bank Name	Account Number	Branch Address

(c) Does the Company, or is it contemplated that the Company will, regularly receive letters of credit from customers or other third parties to secure payments of sums owed to the Company? The following is a list of all letters of credit naming the Company as beneficiary thereunder:

LC Number	Name of LC Issuer	LC Applicant

4. MATERIAL CONTRACTS

(a) Attached are copies of all loan or other financing agreements, inter-creditor agreements and guaranties to which the Company is a party, together with a schedule of all outstanding obligations thereunder or in respect thereof;

(b) Attached are copies of all mortgages, deeds of trust, pledges and security agreements to which the Company is a party;

(c) Attached are copies of all leases of real property to which the Company is a party;

(d) Attached are all agreements regarding mergers and acquisitions that have been entered into within the last two years, whether or not consummated, to which the Company is a party;

(e) Attached are all material contracts not otherwise covered above to which the Company is a party to or in which the Company has an interest;

(f) Attached is a form customer contract.

5. ENCUMBRANCES

The property of each Loan Party is subject to the following liens or encumbrances:

Name of Holder of Lien/Encumbrance	Description of Property Encumbered

6. LITIGATION

(a) Attached is a complete list of pending and threatened litigation or claims involving amounts claimed against the Company in an indefinite amount or in excess of $50,000 in each case, including all administrative, governmental or regulatory investigations or proceedings;

(b) Attached is a complete list of all claims which the Company has against others (other than claims on accounts receivable), which the Company is asserting or intends to assert, and in which the potential recovery exceeds $50,000 in each case.

7. AFFILIATE TRANSACTIONS

Attached are copies of any agreements, including any tax-sharing agreements, loan agreements and notes, between the Company and of its affiliates.

8. TAXES & INVESTIGATIONS

(a) The following tax assessments are currently outstanding and unpaid against the Company:

Assessing Authority	Amount and Description

(b) The following is a description of any pending or threatened audits or disputes with any taxing authority involving the Company: ________________________________;

(c) Attached are copies of the first page of the Company's tax filings for the prior five (5) years.

9. EMPLOYEE BENEFIT PLANS

Attached is a list of each employee pension benefit plan, revenue or profit-sharing plan, multiemployer plan or other pension or employee benefit plan maintained by between the Company.

10. INSURANCE

Attached is a list of all insurance policies maintained by between the Company, indicating the insurer, the policy number, the type of coverage and the limits of coverage.

11. OFFICERS, DIRECTORS AND MANAGERS OF THE LOAN PARTIES

The following are the names and titles of the officers of the Company:

Office/Title	Name of Officer

12. MISCELLANEOUS

(a) Indebtedness: Attached is a list of any current indebtedness of the Company that is to be paid off at the closing of the loans, including each creditor's name, a contact person, and the contact person's phone and fax numbers, and the approximate amount of such indebtedness. Also attached are copies of the documentation for the Company's existing indebtedness for borrowed money and letters of credit that will remain in place after the closing of the loans;

(b) Necessary Consents: Attached is a list of any consents or approvals that will be required in connection with the closing of the loans;

(c) Regulatory/Licensing Matters: Please describe any regulatory/licensing compliance required of the Company due to the specific nature of its business;

(d) Noncompliance: Please provide copies of any notices received by the Company for noncompliance with applicable law or regulation, including environmental and safety statutes and regulations.

13. LEGAL COUNSEL

The following attorney will represent the Company in connection with the loan documents:

Attorney	Law Firm	Telephone	Email

The Company agrees to advise you of any change or modification to any of the foregoing information or any supplemental information provided on the exhibits or attachments hereto and, until such notice is received by you, you shall be entitled to rely on the information contained herein and on the supplemental information provided on such exhibits and attachments and presume that all such information is true, correct and complete.

Date: DD/MM/YYYY__
[Company Name]
By:
Name:
Title:
Email:
Phone: