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Draft legislative guide on secured transactions

Note by the Secretariat*

Addendum

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IX. Rights and obligations of third-party obligors

A. General remarks

1. Introduction

1. When the encumbered asset in a secured transaction consists of a right against a third party, the secured transaction is necessarily more complicated than when the encumbered asset is a simple object such as an item of equipment. Such rights against third parties may include "receivables", "negotiable instruments", "negotiable documents", "rights to proceeds under an independent undertaking" and "rights to payment of funds credited to a bank account" (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). While these rights against third parties differ from each other in important ways, they have a critical feature in common: the value of the encumbered asset is the right to receive performance from a third-party obligor.

2. Depending on the nature of the right against a third party that is an encumbered asset, this Guide uses varying terminology to describe the third-party obligor. When the right is a receivable, for example, the third-party obligor is referred to as the "debtor of the receivable" and when the obligation is the right to proceeds under an independent undertaking, the third-party obligor is referred to as the "guarantor/issuer, confirmer or other nominated person" (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

3. When the encumbered asset is a right against a third-party obligor, the secured transaction affects not only the grantor and the secured creditor but also the third-party obligor. Accordingly, laws typically provide appropriate protection against adverse effects on the third-party obligor, especially since that obligor is not a party to the secured transaction. On the other hand, those protections should not unduly burden the creation of security rights in rights against third-party obligors, since security rights facilitate the extension of credit by the secured creditor to the grantor, and thus by the grantor to the third-party obligor.

2. Effect of a security right on the obligations of a third-party obligor

(a) General

4. It is generally recognized that it would be inappropriate for a security right in a right to performance from a third-party obligor to change the nature or magnitude of the third-party obligor's obligation. For example, article 15 of the United Nations Convention on the Assignment of Receivables in International Trade[1] (the "United Nations Assignment Convention") permits no change in the obligation, other than the identity of the person to whom payment is owed (and, with some limitations, the address or account to which payment is to be made; see para. 8 below). This principle is equally applicable to third-party obligors in the case of rights other than receivables (such as the ones mentioned above).

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[1] United Nations publication, Sales No. E.04.V.14.

5. When a negotiable instrument or negotiable document evidences the right against the third-party obligor, this principle is already reflected in law that is well developed in most States and that details the effect of an assignment on the obligation of the obligor ("law governing a negotiable instrument" is broader than "negotiable instrument law"; see A/CN.9/631/Add.1, para. […]). Thus, there is no need for secured transactions law to recreate those rules. Accordingly, this Guide generally defers to those bodies of law for effectuation of this principle. Similar protections exist under the law governing bank accounts and the law and practice governing independent undertakings, and this Guide defers to them as well.

(b) Effect of a security right on the obligations of the debtor of the receivable

6. While the effect of a security right on the obligor of a negotiable instrument or negotiable document is well developed in most States, this is not always the case with respect to a receivable that is the subject of a security right. Accordingly, this Guide addresses the effect of a security right on the obligation of the debtor of the receivable in some detail. For the most part, the Guide draws its policies from the analogous rules in the United Nations Assignment Convention.

7. In line with the approach of the United Nations Assignment Convention, the Guide covers not only security rights in receivables but also pure outright transfers and transfers by way of security (see A/CN.9/631, recommendation 3; for the definition of the terms "assignment", "assignor" and "assignee" and related terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). Therefore, the discussion covers the debtor of the receivable in transactions in which the receivable has been transferred outright or utilized as an encumbered asset (in an outright assignment for security purposes or an assignment by way of security).

8. The United Nations Assignment Convention provides that, with few exceptions, the assignment of a receivable does not affect the rights and obligations of the debtor of the receivable without its consent. Permitted effects include only changes in the person, address or account to which the debtor of the receivable is to make payment. So as not to impose hardship on the debtor of the receivable that might result from the change in the person, address or account to which payment is to be made, though, the United Nations Assignment Convention prevents any instruction to the debtor of the receivable changing the person, address or account of payment, from changing the currency of payment or the State in which payment is to be made, unless the change is to the State in which the debtor of the receivable is located (see article 15 of the United Nations Assignment Convention and A/CN.9/631, recommendation 114).

9. When the assignment of a receivable is an outright transfer, the ownership of the right to receive performance from the debtor of the receivable has changed, but this does not necessarily mean that the party to whom payment is to be made will also change. This is because, in many cases, the assignee will enter into a servicing or similar arrangement with the assignor pursuant to which the latter obtains performance on behalf of the former.

10. Similarly, when the assignment of a receivable involves the creation of a security right, the assignment does not necessarily mean that the party to whom payment is to be made will change. In some cases, the arrangement between the

assignor and the assignee will be that payments are to be made to the assignor (at least before any default by the assignor). In other cases, though, the arrangement will be that payments are to be made to the assignee.

11. In view of the fact that the obligation of the debtor of the receivable will be discharged only to the extent of payment to the right party (and may not be discharged if payment is made to a different party), the debtor of the receivable has an obvious interest in knowing the identity of the party to whom payment is to be made. Thus, many legal systems protect the debtor of the receivable by providing that the debtor of the receivable is discharged by paying in accordance with the original contract until such time as it receives notification of the assignment and of any concomitant change in the person or address to which payment should be made. This principle provides important protection to the debtor of the receivable since it avoids the possibility that a payment will be found not to discharge the debtor of the receivable because the payment was made to a party that was no longer the creditor of the receivable, even though the debtor of the receivable was unaware of the change in the creditor of the receivable (see art. 17, para. 1, of the United Nations Assignment Convention and A/CN.9/631, recommendation 116, subpara. (a)).

12. Once the debtor of the receivable has been notified of the assignment and any new payment instructions, however, it is appropriate to require the debtor of the receivable to pay in accordance with the assignment and instructions (subject to the limitation described in para. 8 above, that the instructions may not change the currency of payment or the State in which payment is to be made unless the change is to the State in which the debtor of the receivable is located). This principle is critical to the economic viability of receivables financing. If the debtor of the receivable were to continue to be able to pay the assignor, this could deprive the assignee of the value of the assignment, especially when the assignor is in financial distress (see art. 17, para. 2, of the United Nations Assignment Convention and A/CN.9/631, recommendation 116, subpara. (b)).

13. As noted above, it would be inappropriate for an assignment of a receivable to change the nature or magnitude of the obligation of the debtor of the receivable. One implication of that principle is that the assignment should not, without the consent of the debtor of the receivable, deprive the debtor of the receivable of defences or rights of set-off that it could raise against the assignor in the absence of an assignment (see art. 18 of the United Nations Assignment Convention and A/CN.9/631, recommendation 117).

14. This principle should not, however, prevent the debtor of the receivable from agreeing that it may not raise against an assignee defences or rights of set-off that it could otherwise raise against the assignor. The effect of such an agreement is to confer on the receivable the same sort of “negotiability” that enables negotiable instruments to be enforced by “holders in due course” or “protected purchasers” without regard to defences or rights of set-off (for the meaning of the term “protected holder”, see, e.g., art. 29 of the United Nations Convention on International Bills of Exchange and International Promissory Notes[2] (the “UNCITRAL Bills and Notes Convention)). As the receivable could have been embodied in a promissory note or similar negotiable instrument with the agreement of the debtor of the receivable, there is no reason to prevent the debtor of the

[2] Ibid., Sales No. E.95.V.16.

receivable from agreeing to the same result as would have been achieved by the use of a promissory note or similar negotiable instrument (see A/CN.9/631, recommendation 118, subpara. (a)). However, in most States, as in the UNCITRAL Bills and Notes Convention, there are certain defences, which can be raised even against a holder in due course or other protected purchaser (see, e.g., para. 1 of art. 30 of the UNCITRAL Bills and Notes Convention). The same result should follow in the context of agreeing not to raise defences against the assignee of a receivable (see art. 19, para. 2, of the United Nations Assignment Convention and A/CN.9/631, recommendation 118, subpara. (b)).

15. When a receivable is created by contract, it is possible that the debtor of the receivable will agree with its creditor to modify the terms of the obligation. If such a receivable is the subject of an assignment, the effect of that modification on the rights of the assignee must be determined. If the modification occurs before the assignment, this means that the right assigned to the assignee is the original receivable as modified by the agreement of the debtor of the receivable and its creditor. If the modification occurs after the assignment, but before the debtor of the receivable has become aware that the creditor has assigned the receivable, it is understandable that the debtor of the receivable would believe that the agreement of modification was entered into with the creditor of the receivable and, thus, would be effective. Accordingly, legal systems generally provide that such a modification is effective as against the assignee (see, e.g., art. 20, para. 1, of the United Nations Assignment Convention and A/CN.9/631, recommendation 119, subpara. (a)).

16. If the agreement to modify the terms of the receivable is entered into between the debtor of the receivable and the assignor after the assignment has already occurred and after the debtor has been notified of it, such a modification is usually not effective unless the assignee consents to it. The reason is that, at this point, the assignee's right in the receivable has already been established and such a modification would change the assignee's rights without its consent. Some legal systems, however, provide limited exceptions to this rule of ineffectiveness. For example, if the right to be paid on the receivable has not yet been fully earned by performance and the original contract provides for the possibility of modification, the modification may be effective against the assignee. In some cases, such as when the original contract governs a long-term relationship between the debtor and the creditor of the receivable, and the relationship is of the sort that is frequently the subject of modification, the assignee might anticipate that reasonable modifications might be made in the ordinary course of business even after assignment. As a result, some legal systems provide that a modification to which a reasonable assignee would consent is effective against the assignee, even if made after the debtor of the receivable is aware of the assignment, so long as the receivable has not yet been fully earned by performance (see art. 20, para. 2, of the United Nations Assignment Convention and A/CN.9/631, recommendation 119, subpara. (b)).

(c) Effect of a security right on the obligations of the obligor on a negotiable instrument

17. In most States, the law governing negotiable instruments is well developed and contains clear rules as to the effect of a transfer of an instrument on the obligations of parties to the instrument. As a general matter, those rules continue to apply in the

context of security rights in negotiable instruments (see A/CN.9/631, recommendation 121).

18. Thus, for example, the secured creditor is not able to collect on the negotiable instrument except in accordance with the terms of the negotiable instrument. Even if the grantor has defaulted on its obligation to the secured creditor, the secured creditor cannot enforce the negotiable instrument against an obligor under the negotiable instrument except when payment is due under the negotiable instrument. For example, if a negotiable instrument is payable only at maturity, a secured creditor is not permitted to require payment on the negotiable instrument prior to its maturity, except as set forth in the terms of the negotiable instrument itself.

19. In addition, the secured creditor, unless otherwise agreed by the obligor, cannot collect on the negotiable instrument except in accordance with the law governing negotiable instruments. Typically, as a matter of the law governing negotiable instruments, for the secured creditor to collect on the negotiable instrument, the secured creditor must be a holder of the negotiable instrument by being in possession of it with any necessary endorsement. Otherwise, the obligor will not be assured of obtaining a discharge on the negotiable instrument by paying the secured creditor. Accordingly, the obligor is often permitted to insist, under the law governing negotiable instruments, on paying only the holder of the negotiable instrument. However, in some legal systems, a transferee of an instrument from a holder can enforce the instrument if the transferee has possession.

20. Under the law governing negotiable instruments, the secured creditor may or may not be subject to the claims and defences of an obligor on the instrument. If the secured creditor is a protected holder of the negotiable instrument, the secured creditor is entitled to enforce the negotiable instrument free of certain claims and defences of the obligor. These claims and defences are the so-called “personal” claims and defences, such as normal contract claims and defences, which the obligor could have asserted against the prior holder. However, the secured creditor, even as a protected purchaser, remains subject to so-called “real” defences of the obligor, such as lack of legal capacity, fraud in the inducement or discharge in insolvency proceedings.

21. If the secured creditor is a holder of the negotiable instrument but not a protected holder, the secured creditor, while entitled to collect on the negotiable instrument, is usually subject to the claims and defences that the obligor could have asserted against a prior holder of the negotiable instrument. These claims and defences include all “personal” claims and defences unless the party liable on the negotiable instrument has effectively waived its right to assert such claims and defences in the negotiable instrument itself or by separate agreement with the secured creditor.

(d) Effect of a security right on the obligations of the depositary bank

22. In legal systems in which a security right may be created in a right to payment of funds credited to a bank account only with the consent of the depositary bank, the bank has no duty to give its consent. In legal systems where the depositary bank’s consent to the creation of the security right is not required, the rights and obligations of the depositary bank may nonetheless not be affected without its consent (see A/CN.9/631, recommendation 122, subpara. (a)). In both cases, the

reason lies in the critical role of banks in the payment system and the need to avoid interfering with banking law and practice.

23. The reason for not imposing duties on a depositary bank or changing the rights and duties of the depositary bank without its consent is that imposing such duties without the bank's consent may subject the bank to undue risks that it is not in a position to manage without having appropriate safeguards in place. The depositary bank is subject to significant operational risks, with funds being debited or credited to bank accounts on a daily basis, often with credits being made on a provisional basis, and sometimes involving other transactions with its customers. These risks are compounded by the legal risk to the depositary bank of failing to comply with laws dealing with negotiable instruments, credit transfers and other payment system rules in its day-to-day operations, as well as the risk of not complying with certain duties imposed on the depositary bank by other law, such as laws requiring it to maintain the confidentiality of its dealings with its customers. In addition, the depositary bank is typically subject to regulatory risk under laws and regulations of the State designed to ensure the safety and soundness of the depositary bank. Finally, the depositary bank is subject to reputational risk in choosing the customers with which it agrees to enter into transactions.

24. The experience in those States where the depositary bank's consent to new or changed duties is required suggests that the parties are often able to negotiate satisfactory arrangements so that the depositary bank is comfortable that it is managing the risks involved given the nature of the transaction and the bank's customer.

25. In particular to avoid any interference with the depositary bank's rights of set-off against the account holder, legal systems that permit the depositary bank to obtain a security right in the right to payment of funds credited to a bank account held with the bank, provide that the bank maintains any rights of set-off it might have under law other than the secured transactions law (see A/CN.9/631, recommendation 122, subpara. (b)).

26. The same principles apply with respect to the third-party effectiveness, priority and enforcement of a security right in a right to payment of funds credited to a bank account. For example, in legal systems that refer to the notion of "control" with respect to the third-party effectiveness of a security right in a right to payment of funds credited to a bank account, there are appropriate rules to safeguard the confidentiality of the relationship of a bank and its client (for the definition of "control", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). Such rules provide, for example, that the bank has no obligation to respond to requests for information about whether a control agreement exists or whether the account holder retains the right to dispose of funds credited to its bank account (see A/CN.9/631, recommendation 123, subpara. (b)).

27. In legal systems in which the security right in a bank account is made effective against third parties by registration of a notice in a public registry or by acknowledgment on the part of the depositary bank, the notice or acknowledgement may or may not impose duties on the depositary bank to follow instructions from the secured creditor as to the funds in the account. If such duties are not imposed on the depositary bank under the applicable laws of a particular State, the secured creditor's right to obtain the funds in the bank account upon enforcement of the

security right would usually depend upon whether the customer-grantor has instructed the depositary bank to follow the secured creditor's instructions as to the funds or the depositary bank has agreed with the secured creditor to do so. In the absence of such instructions or agreement, the secured creditor may need to enforce the security right in the bank account by using judicial process to obtain a court order requiring the depositary bank to turn over the funds credited to the bank account to the secured creditor.

28. In legal systems in which the depositary bank may negotiate its favourable priority position with the bank account holder and its creditors, the bank has no duty to subordinate its rights to the security right of another creditor of the account holder. Even if, in order to facilitate the creation, effectiveness against third parties, priority and enforcement of a security right in a right to payment of funds credited to a bank account, the secured creditor is willing to become the depositary bank's customer with respect to the bank account, the depositary bank has no duty to accept the secured creditor as the bank's customer.

(e) Effect of a security right on the obligations of the guarantor/issuer, confirmer or nominated person under an independent undertaking

29. The rights and duties of the guarantor/issuer, confirmer or nominated person with respect to an independent undertaking are quite well developed under the law and practice governing independent undertakings (for the definitions of these terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). This highly developed law and practice has facilitated the usefulness of independent undertakings, particularly in international trade. Accordingly, the development of secured transactions law with respect to independent undertakings should take great care to avoid interfering with these useful commercial mechanisms.

30. In order to avoid such interference, it is helpful to distinguish between the independent undertaking itself and the right of a beneficiary of such an undertaking to receive a payment (or another item of value) due from the guarantor/issuer or nominated person. While providing for a security right in the former without interference with the usefulness of the independent undertaking is a delicate task, a security right in the latter carries fewer risks because it relates only to the right of the beneficiary and would not have an effect on the guarantor/issuer, confirmer or a nominated person.

31. This Guide recommends rules facilitating the use of the right to proceeds under an independent undertaking as collateral, but with strict conditions designed to avoid negative effects on guarantors/issuers, confirmers or nominated persons (and, thus, on the usefulness of independent undertakings).

32. A cardinal principle is that a secured creditor's rights in proceeds under an independent undertaking should be subject to the rights, under the law and practice governing independent undertakings, of the guarantor/issuer, confirmer or nominated person. Similarly, to avoid undermining the independence of the undertaking, a transferee-beneficiary normally takes the undertaking without being affected by a security right in the proceeds under the independent undertaking of a transferor. For the same reason, if the guarantor/issuer, confirmer or nominated person has a security right in the proceeds under an independent undertaking, their

independent rights are not adversely affected (see A/CN.9/631, recommendation 24).

33. Equally important is the principle that a guarantor/issuer, confirmer or nominated person should not be obligated to pay any person other than a confirmer, a nominated person, a named beneficiary, an acknowledged transferee of the independent undertaking or an acknowledged assignee of the proceeds under an independent undertaking (see A/CN.9/631, recommendation 125). If the guarantor/issuer, confirmer or nominated person acknowledges a secured creditor or transferee of the proceeds under an independent undertaking, the secured creditor or transferee may enforce its rights against the person that made the acknowledgement, since the independence of the undertaking is not compromised (see A/CN.9/631, recommendation 126).

(f) Effect of a security right on the obligations of the issuer or other obligor under a negotiable document

34. In most States, the law governing negotiable documents is well developed and contains clear rules as to the effect of a transfer of a document on the obligations of parties to the document. As a general matter, those rules continue to apply in the context of security rights in negotiable documents (see A/CN.9/631, recommendation 127).

35. This means, inter alia, that the right of a secured creditor to enforce a security right in a negotiable document and, thus, in the goods covered by it, is limited by the law governing negotiable documents. The limit is that the goods covered by the negotiable document are in the hands of the issuer or other obligor under that document, and the issuer's or other obligor's obligation to deliver the goods typically runs only to the consignee or to any subsequent holder. Thus, if the negotiable document was not transferred to the secured creditor in accordance with the law governing negotiable documents, the issuer or other obligor will have no obligation to deliver the goods to the secured creditor. In such a case, the secured creditor may need to have a court or other tribunal order the transfer of the document to the secured creditor (or to a person designated by the secured creditor), or otherwise order the issuer or other obligor to deliver the goods to the secured creditor or other person designated by the secured creditor.

B. Recommendations

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