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Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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V. Publicity

A. General remarks

1. Introduction

1. As explained above (see A/CN.9/WG.VI/WP.2/Add.3, paras. 10 and 15-20), there is a need to facilitate the granting of non-possessory security rights. Non-possessory security, though known in the past, began to re-emerge only in the nineteenth century and is still restricted or even outlawed altogether in some States. This approach has been traditionally explained with the perceived need to protect other creditors from the misleading impression of false wealth created by the debtor's retention of possession. However, the false wealth concern standing alone is a somewhat outmoded and insufficient rationale. In a credit-dominated commercial world, third persons should not be surprised to discover that a debtor's assets are charged with security, or are subject to a supplier's or lessor's prior title. However, it does not follow that a secured transactions regime can safely dispense with any publicity requirement for non-possessory security. A reliable and effective system of publicity has significant efficiency and dispute-avoidance benefits.

2. First, publicity enables prospective secured creditors to ascertain whether the relevant assets have already been charged with security in favour of a prior creditor, so as to be able to assess their priority ranking as against competing security rights. In the absence of publicity, secured creditors must rely on debtor assurances or undertake extensive factual inquiries. This tends to impede access to credit by debtors without an established credit record, and to restrict credit market competition by tying debtors to creditors with whom they have built up an established relationship of trust.

3. Second, publicity is needed to deal adequately with the consequences of an unauthorized disposition of the encumbered assets by the debtor. In the absence of publicity, legal systems are forced to choose between protecting secured creditors against the consequences of debtor misbehaviour, or protecting innocent transferees against the risk of secret liens of which they have no knowledge or means of acquiring knowledge. Publicity eliminates the need to mediate between these two extremes, and enables legal systems to preserve the security of all consensual dealings in movable assets.

4. Third, publicity reduces litigation to resolve suspicions of fraudulent antedating of security instruments by providing an objective mechanism for evidencing the effective date of security. Admittedly, the risk of fraudulent antedating is less pervasive in a credit market dominated by specialized and

reputation-sensitive financial institutions. Moreover, the problem could be addressed by requiring the security agreement to comply with certain formalities without requiring that notice of the security right also be publicized. However, the added element of publicity enables unsecured creditors to more efficiently assess whether there is any unencumbered value left in a debtor's assets to satisfy their own claims. In the absence of publicity, the only source of information is the debtor who may not be a cooperative or reliable source, forcing creditors to initiate what may turn out to be futile enforcement proceedings.

5. In the immovables context, the need for publicity has been largely satisfied by the establishment of a publicly accessible registry. A land registry is designed to provide comprehensive publicity to third parties of the current state of title to a particular immovable, including any encumbrances on title granted by the registered owner. Many States have established similar registries for a limited number of high value movables (e.g. ships, aircraft, motor homes and sometimes other road vehicles). But most forms of movable property are not capable of being described with sufficient particularity, or are too dynamic or impermanent, to make the land title registry model workable. This is particularly true for intangible rights and for funds or universalities of circulating assets, such as inventory and claims.

6. In order to resolve these practical difficulties, the concept of a pure encumbrance registry has emerged. Instead of being organized by reference to title to the encumbered asset, registrations are entered and searched by reference to the name of the grantor. The question of the grantor's title, and whether the encumbered asset actually exists, is left to be determined by reference to off-record events and facts.

7. The idea of an encumbrance registry for security in movables dates back to the early nineteenth century and is historically associated with States in the common law tradition. However, the concept is no longer viewed as a particularly common law phenomenon. Such registries are increasingly accepted as necessary infrastructure for a modern and comprehensive system of non-possessory security everywhere. This development is reflected in the model secured transactions laws of the European Bank for Reconstruction and Development and the Organization of American States, and in the recent Convention on International Interests in Mobile Equipment.

8. This chapter begins by examining the essential pre-requisites for an effective and efficient encumbrance registry. The discussion then turns to the question of whether public registration should be required even for possessory security rights, and whether alternative modes of publicity should be admitted. The chapter concludes by examining the question of whether publicity should operate as a pre-condition to the effectiveness of the security between the parties, or only against third parties. While this necessarily requires some more general analysis of the third-party effects of security, a complete discussion of the relationship between publicity and priority is left to the separate chapter on priority (Chapter VII).

2. Public registration for non-possessory security in movables

a. Title transactions vs. security transactions

9. Although a pure encumbrance registry is not designed to provide evidence of the grantor's title to the encumbered asset, it does not follow that all title transactions should be excluded. The early encumbrance registries were primarily designed to give secured creditors a means of publicly evidencing security to protect themselves from allegations of fraudulent antedating by other creditors. This has remained the focus in some systems with the result that public registration is required only for security rights involving assets already owned by the debtors (e.g. corporate charges). Since security generated by retention of title under a sale or lease does not by definition involve an attempt to extract value from the grantor's existing patrimony, registration is not required.

10. In the newer registry regimes, however, protection against fraudulent antedating is only an incidental aspect of the registry function. The principal focus is on true publicity. The aim is to maximize the ability of third persons to determine whether assets in the debtor's possession and control belong to the debtor or are subject to a property right in favour of a third person. To ensure maximum publicity, all security arrangements, whether constituted by way of security in the strict sense, or constituted by way of the transfer or retention of title, must be registered to preserve their third-party effectiveness.

11. Indeed, similar publicity concerns arise whenever a person is permitted to remain in possession and control of assets owned by another, even when ownership is not being employed for the purposes of securing debt. This favours extending the scope of the registry to all non-possessory transactions that are sufficiently pervasive in commercial practice to create the potential for third party prejudice, even when they do not function to secure debt. This trend is reflected in the extension of the Convention on International Interests in Mobile Equipment beyond charges and retention of title agreements in favour of sellers to include aircraft leasing arrangements, regardless of whether the lease operates as a security or represents a true lease in the sense that the rental payments accurately reflect the use value of the aircraft over the relevant term. This approach also operates to reduce litigation on the appropriate characterization of transactions at the economic borderline between security and ownership, retention of title sales agreements and leasing transactions being the principal source of difficulties. That issue cannot be completely eliminated since it is also relevant at the level of enforcement. But the imposition of a common publicity requirement reduces the potential for disputes.

12. To avoid regulatory overreach, some means of identifying the range of transactions caught by the registry is needed. Where the title transaction operates to secure debt, this can be accomplished by the use of a functional definition of security to include any transaction, regardless of the location of title as between creditor and debtor, that operates to secure performance of an obligation.

13. Where the transaction is not secured in nature, even from a functional perspective, the general legislative tendency has been to revert to a more formalistic approach. Those transactions which are regarded as representing the most common

potential source of difficulty in the particular country are identified by reference to their formal structure. In regimes which have adopted this approach, the following illustrative list emerges (although not all regimes necessarily include all four transactional types within their scope):

(i) long term (e.g. in excess of one year) leases even where these do not function to secure the equivalent of the acquisition value of the leased goods;
(ii) commercial consignments under which inventory is delivered to an agent for re-sale to the public unless the agent is widely known to creditors as dealing only in consigned inventory, e.g auctioneers and art dealers;
(iii) outright assignments (i.e. sales) of account receivables or claims; and
(iv) outright sales of goods, if the seller is left in possession beyond a reasonable term.

14. The difficulty with this approach is that it is historically oriented. Transactional types that have posed publicity difficulties in the past are identified by their nominal structure. The future may bring new transactional structures that raise equivalent publicity concerns. Consequently, it may be preferable to instead use a problem-oriented concept so as to require registration in any situation where a person is left in possession or control of movable assets belonging to another beyond what is considered a statutorily ordained reasonable period.

b. Consensual vs. non-consensual security rights

15. In principle, a true publicity registry for movable security should extend to all security rights, whether created by operation of law or by agreement. Despite the difference in their method of constitution, they raise identical publicity concerns.

16. However, much depends on the third-party effects of the particular non-consensual security right. If the public policy basis for the non-consensual security right is sufficiently strong to require awarding the creditor super-priority over all other creditors, secured or unsecured, prior or subsequent, then publicity provides little practical benefit. But if ranking is based on a first-in-time rule, or if the holder of a non-consensual security right has a general right to pursue the encumbered asset even in the hands of bona fide buyers (droit de suite), there is much to be said for subjecting the non-consensual secured creditor to the same comprehensive publicity and priority framework that applies to consensual secured creditors.

17. A growing number of registry regimes permit judgement creditors (i.e. creditors whose claim has been recognized in a court judgement) to register a notice of judgement in the movables security registry, with registration creating the equivalent of a general security right against the judgement debtor’s assets. This approach indirectly promotes the prompt satisfaction of judgement debt without the expense and burden of having to pursue active judgement execution measures. Once the judgement is publicized, the judgement debtor is forced in practice to satisfy the debt and terminate the registration in order to be able to sell its assets or use them as security for further debt.

c. A single encumbrance registry vs. multiple encumbrance registries

18. Reflecting the ad hoc evolution of non-possessory security, unreformed registration regimes typically have separate registries depending on the nature of the assets (e.g. book debts) or the status of the grantor (e.g. corporations) or the formal nature of the security device (e.g. mortgages, charges, assignments) or even the status of the secured creditor (e.g. banks).

19. So long as the focus of registration was on protection against fraudulent antedating, the decentralized and frequently overlapping nature of encumbrance registries did not matter greatly. But with the modern shift in focus towards maximizing publicity, the existence of multiple overlapping registries detracts from the publicity function and creates uncertainty in determining the priority or third-party effects of competing security rights granted by the same debtor in the same assets but registered in different registries.

20. Consequently, the more modern regimes create a centralized registry venue for all security rights and analogous transactions. This, in turn, has enabled registration to provide a common presumptive formula for ranking interests according to a simple first-to-register rule (although retention of title agreements and functionally similar arrangements are normally given special protection from the consequences of that rule).

21. Centralization has been greatly aided by developments in computer technology. Computerization enables all registrations, regardless of the nature of the assets or the status of the parties, to be entered into a single data base while still permitting multiple access points for both registrants and searchers.

d. Notice vs. document filing

22. Because their primary purpose was to provide objective proof against fraudulent antedating, the early regimes tended to impose rather onerous registration requirements. An actual copy of the security agreement had to be filed, sometimes accompanied by affidavits of good faith (with respect to other creditor rights) and execution. This approach imposed a counterproductive level of transaction costs and risk on secured creditors, and created uncertainty as to whether registration effected publicity against third persons as to all the contents of the filed documentation, or only certain essential terms.

23. The modern registry regimes have radically simplified the registration process. Instead of having to file the actual security documentation, all that is needed is a simple notice setting out the basic information necessary to alert third parties to the nature and scope of the security. Relative to document-filing, notice-filing offers the following benefits:

(i) a reduced administrative and archival burden for the registry;
(ii) reduced transaction costs for secured creditors with a corresponding reduction in the risk of error;
(iii) enhanced confidentiality of the debtor's affairs;

(iv) increased flexibility in the negotiation and settlement of the terms of the security agreement; and

(v) greater certainty and enhanced publicity for third party registry searchers.

e. Timing of registration

24. In a notice-filing system, it is unnecessary, as a practical matter, for the security agreement to have been concluded in order for registration to be effected. Whether advance registration should be authorized as a matter of policy is more controversial. Some regimes permit this. In other regimes, a formal security agreement must first exist, although no funds need yet have been advanced. There are advantages and disadvantages to each approach.

25. Assuming priority among secured creditors is ordered by reference to the time of registration, advance registration enables a secured creditor to establish its priority ranking without having to check for further registrations before actually advancing funds. It also avoids the risk of nullification of the security, or loss of priority, in cases where the underlying security agreement was technically deficient at the point of registration but is later rectified without any intervening prejudice to third persons.

26. On the other hand, advance registration complicates the priority ordering function of registration as against certain categories of third-party rights that vest after the filing is effected but before the security agreement is actually executed so as to constitute the security. As against other registerable rights, there is no difficulty since priority can be ordered by the order of registration, with each security right dating back to the time of registration for this purpose. But where the assets are sold to a buyer, or where an insolvency administrator is appointed, off-record factual evidence will be necessary to determine whether these rights vested before or after the security were actually constituted. However, the same evidentiary burden arises even in a system which disallows advance registration. Since the source of the security is the agreement, not the registration per se, independent proof of the security agreement is still necessary. Although this detracts from the value of registration as a mechanism for avoiding fraudulent antedating, it is a necessary incident of the concept of notice filing.

27. Advance registration also increases the risk of false registrations in cases where the negotiations are aborted and no security is ever granted. This risk can be alleviated by providing a summary procedure for compelling discharge, a procedure which is needed in any event in cases where the secured obligation has been satisfied. Some systems attempt a compromise solution. Advance registration can be made provided it takes place within a specified time period (e.g. 30 days) prior to the execution of the agreement. A grace period of this kind exacerbates the off-record evidentiary inquiry although it might be considered for consumer transactions where the grantor may not have the knowledge or acumen to take advantage of a statutory discharge procedure.

28. The issue of advance registration is, in part, related to the issue of what information must be contained in the registered notice of security. The more

detailed the information that is required, the stronger the case for requiring an anterior security agreement, and the less practical value advance registration will have.

f. Required content of registered notice

29. To have minimal publicity value, a notice of security should identify the grantor and secured creditor and describe the encumbered assets. Because the name of the grantor is the principal search criterion, rules are typically prescribed for determining the correct legal name for registration and searching purposes. For individual grantors, additional information, for instance, date of birth, is sometimes prescribed in order to keep search results within manageable limits. For enterprise grantors, the registry data base is sometimes linked to the business names registry maintained by the particular State so as to facilitate accuracy of entry.

30. Title registries normally require specific identification of the encumbered asset and the security is filed and searched by reference to the specific asset. In an encumbance registry, grantor-name registration eliminates the need for unique item-by-item description, and thereby liberates the scope of the security capable of being efficiently publicized. A single filing is capable of publicizing security in both present and after-acquired assets, and in circulating funds or universalities of assets (e.g. “all claims” or “all inventory”). In such cases, third-party effect relates back to the time of registration, rather than to the time at which the debtor actually acquired rights in the particular asset. The system allows publicity to be effected against the entirety of the debtor’s asset base (e.g. “all present and after-acquired movables”).

31. Such broad-based security rights are controversial. In part, this is because of concerns with the situational monopoly acquired by the first-registered creditor over the debtor’s access to secured financing. In part, it is because all-assets security has the potential to reduce or even eliminate the pool of unencumbered assets available for distribution to execution and insolvency creditors. A secured transactions regime should accommodate these policy concerns. But they should not be used as a justification for imposing arbitrary limits on the scope of assets capable of being effectively publicized by a generic or super generic description in a registered notice of security. These concerns may be better dealt with through the articulation of substantive super-priority rules designed to preserve debtor access to more specialized sources of future financing or to protect particularly vulnerable categories of unsecured creditors. The need for super-priority rules of this kind is taken up in Chapter VII (see A/CN.9/WG.VI/WP.2/Add.7, paras. 33-37). In the consumer financing context, these solutions may need to be supplemented by outright prohibitions on the grant of security in after- acquired consumer assets, a point already addressed in Chapter IV (see A/CN.9/WG.VI/WP.2/Add.4, paras. 22-23 and 55).

32. Even in legal systems that permit generic and super generic descriptions, different approaches are taken to what constitutes an adequate description. In some systems, the registering party is required merely to indicate the generic nature of the encumbered assets (e.g. goods), even if the security right is in fact limited to a specific item (e.g. a single automobile). In other legal systems, the description is required to conform to the actual range of assets to be covered by the filing.

33. Each approach has advantages and disadvantages. A less precise description eases the filing burden for creditors and reduces the risk of descriptive error. It also permits the secured creditor and debtor to amend their security agreement to add new assets within the same generic category without having to make a new registration.

34. On the other hand, such a system has limited publicity value for third parties. In order to ascertain the precise scope of the security, they must obtain assurances from the secured creditor directly or through the debtor. Moreover, even if the existing security agreement covers a smaller range of assets, competing secured creditors who take security in any asset within the registered description will need to secure a waiver of priority from the first-registered creditor. Since priority ranking among secured creditors relates back to the initial registration, an explicit waiver is needed in order to protect the secured creditor against the risk that the grantor may later expand the asset base encumbered with security under a future agreement.

35. Different approaches are also taken to the question of whether the notice must specify the value for which the security is granted. In order to accommodate financing practices with indeterminate obligations (e.g. revolving loan practices), none of the modern systems require the registered notice to specify the actual value of the secured obligation. However, some systems require a maximum value to be entered (for a discussion of maximum sum clauses in the security agreement, see A/CN.9/WG.VI/WP.2, paras. 13 and 16). The main purpose of this requirement is to facilitate the grantor's ability to obtain "second-ranking financing" from other secured creditors using the residual value left in the assets encumbered by the first-registered security. In the absence of such a requirement, the subsequent secured creditor must obtain a positive waiver of priority from the first registered creditor. Otherwise, since priority dates from the time of registration, the second-registered creditor will be subordinated to the extent of any subsequent advances made by the first-registered creditor. Indeed, if the system permits a single registration to publicize security under later agreements between the same parties, this risk arises even if the existing security agreement does not presently contemplate any further future advances.

36. Each approach has advantages and disadvantages. If the notice does not have to specify any maximum value, the first-registered secured creditor and the grantor have complete flexibility to increase the credit facility, or even enter into wholly new credit arrangements, without fear of loss of priority and without additional transaction costs at the level of registration. On the other hand, the grantor's ability to grant security against the residual value of the encumbered assets is reduced unless the first-registered creditor is willing to waive priority. In a competitive credit market, a debtor normally has sufficient leverage to readily obtain a waiver. However, a waiver may not be obtainable on reasonable terms if the security agreement includes a penalty clause for lost interest. At the same time, the protection afforded by the maximum-sum requirement is illusory if hugely inflated estimates are routinely registered. This is not likely to be a problem where the debtor has sufficiently strong bargaining power, but, in that event, the protection may not be needed in the first instance. In other cases, a procedure may have to be introduced to permit the grantor, at least in consumer transactions, to require the

registered amount to be reduced where it does not reflect the actual lending obligation of the secured creditor under any existing agreement between them.

37. Both approaches impose a further inquiry burden on searchers. The parties must be contacted directly to determine the actual current state of accounts. This is true even if the maximum value must be publicized since this amount does not reflect the actual secured obligation outstanding at any given time, but merely the maximum value which the secured creditor is entitled to extract from the encumbered assets by virtue of its security.

g. Need for protection of remote transferees of encumbered assets

38. Real security generally gives the secured creditor the right to follow the encumbered asset into whosoever's hands it may be found. Otherwise, the grantor of the security would have the unilateral power to terminate the security. However, the secured creditor's normal droit de suite may need to be constrained in the context of a grantor-indexed encumbrance registry. In cases where the encumbered assets have been the object of unauthorized successive transfers, prospective purchasers or secured creditors cannot protect themselves by conducting a search according to the name of the immediate holder. The search will not disclose a security interest granted by a predecessor in title.

39. Solutions to this problem can take various forms depending on how a legal regime wishes to strike the balance between preserving security and preserving the reliability of the registry. Minimally, secured creditors should be required to amend their registrations to identify a transferee of the encumbered assets as an additional grantor on pain of subordination to interests acquired in the relevant asset after the secured creditor finds out about a transfer. Some legal regimes may wish to go further and protect all third parties, or at least particularly vulnerable categories of third parties, even where the secured creditor has no knowledge of the debtor's unauthorized disposition.

40. The remote-third party problem can be significantly alleviated by requiring specific-asset identification for effective publicity against purchasers and competing secured creditors in the case of particularly high value assets with reliable numerical identifiers, for example, road vehicles, boats, motor homes, trailers, aircraft, and so forth. Although this reduces the ability of secured creditors to publicize security in after-acquired assets, specific asset identification is practically necessary only for capital assets used in the granter's business and consumer assets used for personal purposes. In the case of inventory, the problem is confined to cases where a dealer in used goods acquire assets subject to a security granted by the seller and then re-sells to the public. Consideration should be given to expanding the scope of the protection afforded to purchasers of assets transferred in the ordinary course of business to protect transferees of such assets. These matters are addressed further in Chapter VII (see A/CN.9/WG.VI/WP.2/Add.7, para. 30).

h. Linkages to registries for immovables

41. Modern secured transactions laws generally permit a movables security right to be granted in immobilized movables, i.e. movable property destined for attachment to land without any loss of separate identity (e.g. a furnace), as well as immovables that may be mobilized, i.e. immovable property destined to become movable (e.g. growing crops). The security right is subject to the same publicity requirements that apply to other categories of movables with one qualification. In order to take effect against persons claiming a right in the land to which the movables are attached or affixed, a notice of security must typically also be filed in the land registry, so at to preserve the comprehensive publicity function of the immovables registry.

42. The establishment of a comprehensive movables encumbrance registry raises the question of whether it is feasible to coordinate publicity where a security agreement covers both immovables and movables. No legal regime appears to have done this. Land registries are primarily organized by reference to the specific asset and operate as records of title as well as encumbrances. To the extent that a supplementary owner name index also exists, a common filing system could be established. But this would require great coordination in the name conventions used in the two systems. Further, the need to maintain the integrity of the land registry would normally require that the security be registered by reference to the specific immovable, not merely the name of the grantor. This is necessary since, in a title registry, there is normally no need at the level of publicity to worry about distinctions between pure security and security created by the transfer or reservation of title in favour of the secured creditor. Adequate publicity is achieved regardless of whether the creditor is identified on the record as the owner of the property or as the holder of an encumbrance on the registered owner's title. The distinction between ownership and security becomes important only at the level of enforcement.

i. Linkages between a general encumbrance registry and asset-specific title registries

43. Similar considerations may create difficulties in coordinating or integrating registrations as between a movables encumbrance registry and asset-specific title registries for movables such as ships, aircraft, road vehicles and intellectual property. In the case of tangible objects, these difficulties can be alleviated to the extent the encumbrance registry builds in a supplementary capacity to carry out searches by reference to numerical asset identifiers. For intellectual property, the obstacles are more formidable because an equivalent asset identification system is not possible, and because the intellectual property registries are not designed for the purpose primarily of facilitating commercial dealings. Whatever approach is taken, a general secured transactions law needs to establish the extent to which filing in an asset- specific register preempts filings in the general movables registry, and to coordinate priorities between the different regimes. This is especially critical with respect to security in intellectual property and license and royalty payments associated with intellectual property, in view of the growing economic importance of property of this kind.

j. Private registration or publication

44. Some regimes eschew a public encumbrance registry as such in favour of more limited notice venues: for instance, entry of a notice in the debtor's own books, or in the books of a notary or court official, or oral declamation, or newspaper notices. Although certain of these notice venues sufficiently address concerns with fraudulent antedating, they lack the permanence and ease of public accessibility needed to ensure true publicity and to establish priority against third persons. If a comprehensive encumbrance registry is established, they can be safely eliminated.

k. Registration and enforcement

45. In some legal systems, a secured creditor is required to register its security right before being entitled to pursue enforcement remedies against the encumbered assets. In other legal systems, registration is not a pre-condition to enforcement. The question of which approach should be taken depends, in part, on who bears the responsibility for notifying third parties with a registered right in the secured assets of the initiation of enforcement action. If this burden is imposed directly on the secured creditor, registration of the enforcing creditor's own right may be unnecessary. If the burden is instead placed on the registrar or some other public official, then registration is needed in order to inform the relevant official of the need to send out notices to other registered claimants. Indeed, in a legal system that adopts the latter approach, publicity by registration would be needed prior to enforcement even in the case of security right initially publicized by dispossession of the debtor.

46. Advance registration of intended enforcement action may also reduce the inquiry burden for competing creditors, both secured and unsecured, who are contemplating the initiation of enforcement action. Otherwise, they will have to make further inquiry of all registered secured creditors in order to determine whether enforcement has been initiated. While some level of inter-creditor communication is invariably needed in practice in order to ensure adequate coordination, registration would at least enable other creditors to focus their inquiry efforts.

3. Debtor dispossession and equivalent control mechanisms

a. Debtor dispossession as a substitute for registration?

47. Possessory security rights are normally exempted from registration, except possibly at the enforcement level. Dispossesion is felt to adequately address the principal sources of potential third-party prejudice. The appearance of false wealth is eliminated, and unauthorized third-party disposition by the debtor becomes impracticable.

48. However, compared with public registration, dispossession less satisfactorily resolves the problem of fraudulent antedating in cases where the historical date on which possession was assumed is significant, for example, in respect of transactions occurring during a suspect period prior to the grantor's insolvency, or

where the possessory pledge comes into competition with a non-possessory security right. It is for this reason that some legal systems impose additional formal requirements designed to establish a certain date for possessory pledges. Registration would more efficiently address the same concern. Although a notice-filing registry does not fully resolve concerns with fraudulent antedating in the case of insolvency, it at least offers a solid evidentiary presumption.

49. The exemption of possessory security rights from registration also lessens the publicity value of the registry and complicates priority ordering. Third parties, including prospective secured creditors, cannot rely wholly on a registry search. They must make further inquiries to ensure that the assets in which security is taken are still within the debtor's possession and control. This is a normal part of the risk assessment process, as an encumbrance registry is inherently less reliable than one designed to record title as well as encumbrances on title. Even if possessory security rights were required to be publicized, secured creditors would still face the risk that the assets encumbered with security had been sold outright by the debtor or seized by an execution creditor. However, the latter risk is considerably reduced in systems that require publicity of judgements by registration. As a system becomes more comprehensive, the case for requiring registration of even possessory security rights becomes stronger.

50. If possession of the encumbered asset by the debtor is permitted to substitute for registration, the question arises whether the secured creditor could relinquish possesion by registering notice of the security, while still permitting the effective date of security to relate back to the date of initial possession. In principle, there is nothing objectionable about this, provided there is no gap in the continuity of publicity. Nonetheless, the result is a further diminishment in the authority of the registry.

b. Quality of possession

51. Assuming that possession is retained as a substitute for registration, the concept should be defined in a fashion that protects against third party prejudice. Purely fictive constructive possession techniques, such as retention of possession by the debtor under an agreement to hold as trustee or agent for the debtor, should be eliminated.

52. Possessory security rights, however, should not be disqualifed simply because the assets remain on the debtor's premises, as in the case of assets stored in a room to which the secured creditor has the exclusive means of access, or warehousing arrangements of the kind described earlier in this guide (see A/CN.9/WG.VI/WP.2/Add.3, paras. 6-7). Provided there is continued and exclusive secured creditor control, the underlying policy of third-party protection is satisfied. Many of these techniques were developed in response to the historical inability of secured creditors to take an effective non-possessory security right. If the alternative of public registration is made generally available, such arrangements will naturally become less prevalent.

c. Symbolic possession

53. Symbolic possession should also remain available where the relevant indicia or documents are widely accepted in general commercial practice as the sole or the most reliable means of transferring or pledging the asset or the value it represents. Illustrative techniques include the delivery, with any necessary endorsement, of share certificates and negotiable instruments and documents of title such as bills of lading or warehouse receipts. Some legal systems have established title certificate systems for road vehicles that enable secured creditors to adequately publicize security rights by taking possession of the title certificate. If the practice is well established and functions well, these forms of possession should also be preserved. On the other hand, delivery of lists of ordinary trade receivables generally should not qualify. These are insufficiently negotiable in commercial practice to adequately protect third persons against the risk of a competing disposition by the debtor (although there may be limited exceptions). Affixation of a plaque or other form of physical notice to the encumbered asset is more problematic because of the potential for abuse. On the other hand, much depends on local commercial practices: the nature of the asset and the required notice may make this form of symbolic possession sufficient.

d. Third-party notice or control

54. Widespread recognition of the ability to pledge goods through delivery of a document of title, such as bills of lading or warehouse receipts, emerged because the third party is in control of the goods. The carrier or storer, as the case may be, is obligated in law to deliver possession of the underlying asset to the person in possession of the document. This illustrates the more general idea that effective dispossession can be achieved through a third person. Moreover, this technique is not confined to the holding of tangible objects. For example, effective dispossession of control over certificated investment securities can be effected by the entry of the name of the secured creditor in the books of the security issuer or by a notation in the books of a clearing agency.

55. A similar idea underlies the rule in some systems by which receivables can be pledged by giving notification to the debtor on the receivable. Because notification obligates the account debtor to make payment of the assigned receivable to the person giving notice, it effectively transfers the right to the monetary value of the receivable from the grantor to the secured creditor who has given notice.

56. In the context of trade receivables financing, debtor notification forms the mechanism for binding the account debtor. However, legal systems that have adopted a public registry for security in movables generally have rejected notification as a mode of publicity against other third parties or a means of establishing priority. Priority in rights to payment between competing secured creditors and assignees is determined instead by the order of registration. This rule enables secured creditors and assignees to more accurately assess and rely on the value of assigned receivables, and facilitates non-notification accounts receivable financing against the bulk of a grantor’s present and future claims.

57. However, some role for third-party notification or control as a method of publicity may be feasible and even preferable for certain high value payment intangibles, such as payments due under an insurance policy or a letter of credit, or even in connection with security granted in bank accounts or investment accounts or securities held with an intermediary. On the other hand, there is no clear consensus on how to resolve such questions as: the extent to which control should be the sole publicity mechanism to the exclusion of registration; whether the third party's consent should be a pre-condition to effective publicity; and the relative priority, especially in the case of security granted in investment property held by an intermediary, in cases where the third party in control has taken security in the same asset, or re-pledged that asset to secure its own debt.

58. Whether debtor dispossession should substitute for registration is an open question. Assuming possessory security rights would not be required to be publicized by registration, the concept of debtor dispossession should be defined in a fashion that minimizes the ability of the grantor to create competing claims in the charged assets in favour of third persons. While this functional test would eliminate purely fictive forms of possession, it would also liberalize the idea of dispossession beyond physical delivery of the charged assets to include constructive possession through documentary intangibles and tangibles, and third party holdings of both corporeal and incorporeal assets on behalf of the secured creditor.

4. Third-party effects of unpublicized security rights

59. Regimes vary on whether publicity is necessary to constitute the security even between the immediate parties, or only for the purposes of effectiveness against third parties. While publicity is principally concerned with the idea of third-party notice, the latter approach may be more appealing, although there are a number of considerations.

60. First, dispossession is essential to the effective constitution of the traditional possessory pledge. For legal systems where the pledge is the typical form of security in movables, public registration for non-possessory security is viewed as a substitute for physical delivery, and is logically a constitutive step.

61. Second, many legal systems are not familiar with the idea of relativity of title, that is, with the idea that property rights can be constituted as against one person (here, the grantor) and not against others (here, competing third- party claimants). Either a full fledged property right exists or it does not.

62. These conceptual concerns cannot be ignored in a legislative guide for secured transactions designed to fit within the various legal cultures. However, concerns about how to formulate the publicity requirement (i.e. as a constitutive or third-party opposability rule) are moot to the extent that the result is the same under both approaches. The difference becomes relevant only if it is desired to give some measure of third-party effect to an unpublicized security right. Different regimes adopt different policies on this point.

63. In some systems, publicity or debtor dispossession as a substitute for publicity is an absolute pre-condition to third-party effectiveness. A security may be

set up against third persons only if and when it is registered or debtor dispossession occurs. Other systems begin from the converse presumption. Security is presumed to take effect as soon as the agreement is constituted, subject perhaps to certain minimal writing requirements. It follows that third parties are protected from an unpublicized security only if they can point to some explicit judicial or legislatively ordained source of protection.

64. The modern legislative tendency in countries with a truly comprehensive encumbrance registry favours denying or limiting the third- party effects of an unpublicized security against most significant categories of third-party interests. Exceptions are limited to transferees of assets who have not given value and possibly buyers in the ordinary course of business who take with actual knowledge of an unpublicized security right, although this latter exception may be more controversial (see A/CN.9/WG.VI/WP.2/Add.7, para. 32). Qualifications based on actual knowledge require a fact-specific investigation and diminish the efficiency of statutory rules by encouraging litigation. Certainly, actual knowledge should not be allowed to defeat the priority obtained by the order of registration or debtor dispossession in a competition between secured creditors. To allow this would undermine the certainty and predictability of the priority rule. There is no unfairness to the holder of the unpublicized right under this approach. The competing creditor could always have protected itself by taking possession or registering in a timely fashion. For this reason, there is no bad faith inherent in a secured creditor asserting priority despite actual knowledge. If the system requires timely registration or possession for priority purposes, the secured creditor should be entitled to rely with confidence on the other creditor's failure to comply in assessing its own priority status.

5. Third-party effects of publicized security rights

65. If registration or debtor disposession is made a pre-condition to the effectiveness of all security rights, it provides a common formula not only for determining the point at which the security right becomes effective against third parties who acquire an intervening interest in the secured assets, but also for determining priority disputes among competing security rights.

66. However, a secured transactions regime should also ensure that the security of ordinary marketplace dealings in movables is not unduly interfered with. This may require the articulation of exceptions to the priority effects of publicity to protect transferees of secured assets who acquire their interest in the ordinary course of the grantor's business, as well as holders and possessory transferees (including competing security claimants) of money and negotiable assets subject to a registered security right.

67. In addition, legal systems may not be prepared to impose the burden of searching and the risks of failure to search on relatively unsophisticated transferees even when they acquire their interest in a non-ordinary course of business transaction. This may require further exceptions in the case of transferees acquiring secured assets for non-business purposes or where the transaction involves a relatively low-value asset or low-transaction amount. On the other hand, the broader the categories of transferees allowed to take free of a registered security

right, the less justification there is for imposing a registration burden on the secured creditor in the first instance. So, consideration might also need to be given to exempting secured creditors from any publicity requirement where they have no right to follow the asset into the hands of innocent transferees. Against this approach must be balanced the value of still requiring publicity as against insolvency and execution creditors.

68. Finally, secured creditors may need to be temporarily excepted from the burden of effecting or preserving publicity to take account of certain marketplace realities. For instance, it would be desirable to give retention-of-title secured creditors a "grace period" to effect publicity in order to facilitate on-the-spot financing in the sales and leasing sectors. Similarly, while security rights in proceeds should, in principle, be subject to the same publicity requirements that would apply to security rights taken in assets of the same kind, provision of a grace period to effect publicity may be needed in order to permit the secured creditor a sufficient opportunity to ascertain the existence and nature of the proceeds. In addition, secured creditors who have publicized by debtor dispossession should be permitted, where the commercial context so demands, to release the secured assets to the grantor for a limited time period without loss of their priority ranking (for example, to enable a debtor to take delivery of charged assets represented by a document of title for the purposes, e.g., of sale or transshipment).

B. Summary and recommendations

69. In principle, security rights should be public, whether by way of possession or control, or by way of registration. It may be possible to develop a compromise solution under which publicity would be necessary as a general rule, subject to only very limited exceptions.

70. Publicity could be a constitutive requirement for an effective security right, or merely a pre-condition to the effectiveness of that right against specified classes of third persons. The related question of whether publicity should be a pre-condition to the exercise of enforcement recourses against the encumbered assets is addressed in Chapter on IX.

71. Whether debtor dispossession should substitute for registration is an open question. If possessory security rights are not be required to be publicized by registration, the concept of debtor dispossession could be defined in a fashion that minimizes the ability of the grantor to create competing claims in the encumbered assets in favour of third persons.

72. As a general rule, the priority effect of security rights against competing claimants should be ordered according to the date at which registration or debtor dispossession was originally effected by the secured creditor, regardless of the presence or absence of actual knowledge of any competing claim, as long as there is no intervening period in which the security right is unpublicized. Exceptions and qualifications to this rule may be necessary to accommodate considerations of fairness and commercial practice (see A/CN.9/WG.VI/WP.2/Add.7, paras. 19-32).

[*Note to the Working Group: The Working Group may wish to consider the concept of a comprehensive encumbrance registry for publicizing notice of security and other non-possessory rights in movables, and for establishing the priority and effectiveness of these rights against third persons. To achieve maximum publicity value, the registry should be centralized in design and comprehensive in scope, covering all significant non-possessory transactions in movables, whether consensual or non-consensual, and whether title or security-based.*

In addition, the Working Group may wish to consider that the notice should contain an identification of the grantor and the secured creditor and a reasonable description of the encumbered assets.

Furthermore, the Working Group may wish to consider whether the notice should specify a maximum amount of secured credit to which the notice applies and whether the filing system should allow the filing of a notice prior to the conclusion of a security agreement and should cover all types of grantor.]