United Nations A/CN.9/WG.VI/WP.9/Add.2

General Assembly

Distr.: Limited
22 July 2003*

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
Fourth session
Vienna, 8-12 September 2003

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

Contents

* This document is submitted three weeks less than the required ten weeks prior to the start of the meeting because of the need to accommodate the completion of consultations.

V.03-86351 (E) 040803 050803

V. Publicity

A. General remarks

1. Introduction

1. A secured creditor needs to be sure that its rights in the encumbered assets have precedence over the rights of third parties. Yet third parties also need protection against the risk of their rights being subordinate to "secret" security rights (in the sense that their existence or possible existence cannot be easily determined in an objective way). Requiring security rights to be publicized before they take effect against third parties offers a means of reconciling these objectives.

2. This chapter focuses on the four most widely accepted modes of publicity. The first is removing possession of the encumbered assets from the grantor. The second is an extension of the idea of dispossession and involves giving the secured creditor control over the value of intangible obligations owed to the grantor by a third party. The third is available only in respect of high value movables for which a State has established a specialized title registry or title certificate system.

3. The fourth and most comprehensive mode of publicity involves filing a simple notice with a limited amount of data about a security right in a secured transactions registry. Unlike a title registry, a secured transactions registry is not concerned with publicizing the current state of title to specific assets. The quality of the grantor's title is determined by off-record events and transactions. Instead, registration is a precondition to the effectiveness of a security right against third parties. Thus, it is the absence of publicity upon which third parties rely in determining whether they are potentially bound by a prior security right.

4. Although it operates on a theory of negative publicity, a secured transactions registry also contributes to positive priority ordering. Most obviously, registration establishes an objectively evidenced and easily verifiable date for ordering priorities among secured creditors and between a secured creditor and other third parties.

5. The entire topic of publicity is inextricably intertwined with that of priority. Although priority is the topic of a separate chapter in this Guide (see A/CN.9/WG.VI.WP.9/Add.3), the nexus between publicity and priority is a continuing theme in this chapter, and the two chapters should be read in conjunction with each other.

6. Like a title registry or title certificate system, the establishment of a secured transactions registry requires governmental investment in the necessary infrastructure whether directly or by contracting with a private sector partner. In the absence of such a system, the third party effectiveness of a non-possessory security right is usually tempered by statutory or judge-made rules designed to protect innocent third parties who acquire a right in the encumbered assets without knowledge of the existence of a prior right. The chapter concludes by comparing a comprehensive registry-based publicity system with this alternative, and by setting forth legislative recommendations.

2. Dispossession

a. General considerations

7. Removing the encumbered assets from the possession of the grantor does not positively publicize the existence of a security right. However, it eliminates the grantor's apparent ownership thereby also reducing the risk of an unauthorized disposition to an unsuspecting third party. Because dispossession signals that the grantor no longer has unencumbered title, it has traditionally been accepted as sufficient to both constitute a security right and make it effective against third parties (see A/CN.9/WG.VI/WP.6/Add.3, para. 67).

b. Possession of the encumbered assets by a third party

8. Dispossession need not involve direct possession by the secured creditor. Possession by a third party on behalf of the secured creditor is sufficient.

9. If the encumbered assets are covered by a document of title (for example, a bill of lading or a warehouse receipt), issuance of the document in the name of the secured creditor ensures that the third party (for example, a carrier or warehouse keeper) is holding on behalf of the secured creditor as opposed to the grantor. If the document of title is negotiable, the carrier or warehouse keeper is normally obligated to deliver the underlying assets to the person currently in possession of the document. It follows that delivery of a properly endorsed negotiable document of title offers an alternative means of removing possession of the underlying assets from the grantor.

10. Possession by a third party does not always require physical removal of the encumbered assets from the grantor's premises. In field warehousing arrangements, a warehousing company acting for the secured creditor assumes control of the grantor's inventory and other encumbered assets through an agent embedded with the grantor. Third parties are protected by virtue of the fact that the grantor's ability to deal with the encumbered assets requires the consent and cooperation of the agent (see A/CN.9/WG.VI/WP.9/Add.1, para.7).

c. Fictive dispossession

11. A paper undertaking by the grantor to hold the encumbered assets as agent for the secured creditor does nothing to protect third parties from being misled by the grantor's apparently unencumbered ownership. Neither does requiring the grantor to periodically deliver lists of encumbered trade receivables to the secured creditor. Fictive dispossession techniques like these represent a pragmatic response to the demand for non-possessory security in regimes in which the pledge is the only formally available security device. Recognition of the general effectiveness of non-possessory security rights along the lines contemplated in this Guide (see A/CN.9/WG.VI/WP.9/Add.1, paras. 15-23) eliminates any pressure to countenance fictive pledges.

d. Priority effects

12. Even in legal systems with a secured transactions registry, dispossession of the grantor can sometimes constitute a superior mode of publicity. For example, in most jurisdictions, if the encumbered assets are covered by a negotiable document of title,

a secured creditor (or buyer) in possession of the document typically takes priority over a secured creditor who publicizes by registration of a notice about its security right (see A/CN.9/WG.VI/WP.9/Add.3, para. 13). This rule avoids interference with the widespread acceptance of negotiable documents of title as the primary vehicle for transferring property rights in the underlying assets during the period that they are covered by the document.

13. In other situations, dispossession may not be the most advantageous mode of publicity. If the encumbered assets are registered in a specialized title registry (see Part A.4), the need to preserve the integrity and reliability of the public record may require giving precedence to secured creditors (and buyers) who publicize their rights by registration.

14. If a competing security right was instead publicized by registration in a general secured transactions registry (see Part A.5), two responses are possible. Priority can be ordered temporally according to the order in which dispossession and registration occurred. Alternatively, preference may be given to the registered security right, regardless of whether dispossession occurred before or after registration.

15. The first approach reduces costs and risk for pawnbrokers and other creditors who routinely rely on possessory security. On the other hand, the second approach averts any temptation on the part of possessory secured creditors to fraudulently antedate the time at which dispossession occurred. It also maximizes the priority ordering value of the secured transactions registry by eliminating the risk for off-record evidence of the precise timing of dispossession.

16. If the first approach is taken, there is the further issue of whether priority dates from the moment of dispossession even if a secured creditor initially publicizes by dispossession and later registers and releases the assets back to the grantor. If so, a second-registered secured creditor would end up having first priority. On the other hand, the first-registered secured creditor could have protected itself by verifying that the grantor was in possession of the encumbered assets at the time that secured creditor obtained its security right.

3. Acquisition of control over intangible obligations

a. Trade receivables

17. In legal systems that accept the negotiability of security certificates (for stocks or bonds), delivery of the certificate with any necessary endorsement transfers the benefit of the obligations owed by the issuer to the secured creditor. As such, it is the functional equivalent of dispossession through the agency of a third party. The same result can be achieved for certificated securities held with a clearing agency by entering the name of the secured creditor in the books of the clearing agency, and for uncertificated securities, by registering the name of the secured creditor in the books of the issuer. In the case of indirectly held investment property, control over the obligations owed by the broker or other intermediary can be transferred either by putting the investment account in the name of the secured creditor, or obtaining the agreement of the intermediary to respond to the directions of the secured creditor.

18. This Guide does not address issues relating to security rights in investment property. Nonetheless, the idea of control as a mode of publicity equivalent to dispossession can be applied to other types of intangible obligations owed by a third party to the grantor. For example, the grant of security in an ordinary trade receivable or other monetary claim entitles a secured creditor, in the case of debtor default, to demand payment from the person owing the obligation subject to the terms of the security agreement. A demand for payment thus transfers practical control over the monetary claim to the secured creditor. For this reason, it might be considered a sufficient mode of publicity equivalent to the transfer of control over investment property.

19. However, a secured creditor generally will not demand direct payment until there is a default on the part of the grantor. Even when monetary claims are sold outright, the assignee will frequently wish to leave collection in the hands of the assignor. In light of these practicalities, it may be preferable to treat a demand for payment simply as a collection or enforcement technique and not a mode of initial publicity. This is particularly appropriate where the option of filing a notice in a secured transactions registry is available to both secured creditors and assignees. Publicity by registration offers a more efficient means of evaluating priority risk at the outset of the transaction particularly where the security covers the grantor's present and after-acquired receivables.

b. Deposit accounts

20. By analogy to the mode of publicity used for indirectly held investment property, control over a deposit account held by a grantor with a financial institution or insurance company can be achieved by putting the name of the secured creditor on the account or obtaining the agreement of the depository institution to respond to the directions of the secured creditor.

21. The depository institution may itself be owed money by the grantor. Rather than going through the artificial exercise of requiring a positive transfer of control, it may be simpler to treat a depository institution that takes security in a customer's deposit accounts as having automatic control by virtue of its status.

22. Whether a secured creditor who publicizes the grant of security in a deposit account by control should have priority over one who publicizes by registration is an open question. The analogy to investment property would suggest a positive answer. The analogy to the assignment of monetary claims would suggest the contrary.

23. If the first approach is taken, there is the further question of whether a depository institution that takes security in its customers' accounts should have priority over other security rights publicized by control. The institution's set-off rights are usually sufficient to protect its counter claims prior to the initiation of enforcement proceedings by a competing secured creditor, independently of whatever priority status the institution has as a secured creditor.

4. Title-based modes of publicity

a. Title registry systems

24. Dispossession and equivalent control techniques are available only if the grantor is prepared to give up ongoing use and enjoyment of the encumbered assets. They are not feasible for publicizing security rights in assets over which the grantor needs to retain control in order to produce its services or products or otherwise generate profit.

25. For limited categories of high value movable assets, a State may have adopted a specialized title registry similar to a land title registry. Where a title registry exists, it offers a convenient venue for publicizing non-possessory security rights in such high-value assets. Ships, aircraft, motor homes, and intellectual property rights (notably patents and trade marks) are the most commonly encountered examples of assets for which title registries exist.

26. A security right (or sale) publicized by registration in a title registry generally takes priority over a security right publicized by dispossession or by registration of a notice of security in a general secured transactions registry. This rule ensures that purchasers of the encumbered assets can rely with full confidence on the title registry records in assessing the quality of the title they are obtaining.

27. Providing a common access point to the records of the title registry and the secured transactions registry so as to enable simultaneous registration and searching of both systems could also accommodate this concern. Advances in computer technology make this feasible as a technical matter. However, there are design and implementation challenges. Title registry systems are generally based on asset-indexing while secured transactions are generally organized by reference to the identity of the grantor. Thus, to enable simultaneous searching, it would be necessary to require both systems to implement the same grantor identifier rules, and to program the title registry to permit grantor-based searching.

b. Title certificate systems

28. Title certificate systems are an alternative method used by some States to publicize the acquisition and transfer of title in movable assets (for example, motor vehicles). Security rights are publicized by a notation on the certificate.

29. A security right publicized by a notation on a title certificate generally takes priority over one publicized by any other method. This rule is necessary if purchasers are to be able to rely on the title certificate in assessing the quality of the seller’s title.

c. Security rights in land-related movables

30. Financing flexibility is enhanced if the regime for security in movables is available to secured creditors who take security in immobilized movables (e.g. a furnace destined to be attached to land), or in mobilized immovables (e.g. growing crops destined to be severed from the land). This would allow a grantor to obtain financing without having to take out a full-fledged and correspondingly more expensive immovables mortgage.

31. Under this approach, the general publicity rules for movables can be applied with one qualification. It would be desirable to require concurrent registration of a notice of security in the immovables title registry to bind third parties who later acquire a registered right in the land to which the movables are attached or affixed, and to apply the priority rules applicable to immovables to such relationships. These rules would preserve the integrity and reliability of the land title record.

5. Registration of the security agreement in a secured transactions registry

32. Another mode of publicity relates to the registration of the security agreement in a secured transactions registry. As is the case with registration in title registries, documents are submitted to and checked by the registrar who then issues a registration certificate that constitutes conclusive evidence of the existence of the registered right. This conclusive evidence certificate is often recognized as the main advantage of document registration. However, the purpose of establishing priority for the registrant while, at the same time, protecting the interests of third parties may be achieved in a more cost- and time-efficient way, that better addresses the needs of modern transactions and does not result in disclosing sensitive data relating to a transaction (see A.5).

6. Registration of a notice of security in a secured transactions registry

a. General considerations

33. A fifth mode of publicity involves filing a notice of the security right in a public registry established for this purpose. Unlike the three modes of publicity already considered, notice filing offers a universal means of effecting publicity, regardless of the nature of the encumbered assets. As such, it contributes to efficient priority ordering, enabling competition among secured creditors and between a secured creditor and other third parties to be settled by reference to the timing of registration.

34. A notice-based secured transactions registry is very different from a title registry or a secured transactions registry based on document filing. A title or a document-filing registry functions as a conclusive source of positive information about the current state of title to specific assets. To protect the integrity of the title record, the registrant is generally required to file the actual title transfer documents or tender them for scrutiny by the registrar.

35. In contrast, a secured transactions notice-filing registry operates on a theory of negative publicity. Registration does not provide positive proof of the existence of the security right. It rather provides a warning to third parties about the possible existence of a security right that allows third parties to take further steps to protect their rights (see para. 54) and constitutes a precondition to the effectiveness of a security right against third parties. In effect, it is the absence of registrations on which third parties rely in concluding that they need not worry about any prior security rights granted by the person with whom they are dealing. It follows that there is no need to require secured creditors to register the security agreement or otherwise prove its existence. Third parties are sufficiently protected by registration of a simple notice identifying the parties and describing the encumbered assets. From the grantor's perspective, protection from unauthorized registrations can be achieved by the registry rules' requiring the named grantor to be informed of any

registration and by establishing a summary administrative procedure to facilitate the removal of unauthorized registrations.

36. Notice filing greatly simplifies the registration process and minimizes the administrative and archival burden on a registry system. It also enhances flexibility during the duration of the financing. So long as the factual particulars set out in the registered notice are not affected, there is no reason why a single notice cannot be accepted as sufficient to publicize successive security agreements between the parties.

37. The concept of a notice-based secured transactions registry has attracted considerable international support. Model systems have been developed by the European Bank for Reconstruction and Development (General Principles of A Modern Secured Transactions Law, 1997; Model Law on Secured Transactions, 1994), the Organization of American States (Model Inter-American Law on Secured Transactions, 2002), and the Asian Development Bank (Law and Policy Reform at the Asian Development Bank: A Guide to Movables Registries, December 2002). The Convention on International Interests in Mobile Equipment, 2001 and the related Aircraft Protocol provide for an international priority regime based on a filing system for interests in aircraft arising under security agreements, leases and title retention sales agreements. The United Nations Assignment Convention also offers notice filing as one of the optional priority systems set forth in its annex.

b. Asset v. grantor indexing

38. A notice of security must be indexed according to established criteria to permit its efficient retrieval. Notices in a secured transactions registry are generally indexed by reference to the identity of the grantor. Asset-based indexing is feasible only for assets that have a serial number or other objectively established unique identifier. Even then, the value of individual items within a generic category (e.g. all tangible movables) may be too modest to justify the cost involved in tracking registrations on an item-by-item basis. In addition, asset-based indexing does not accommodate the registration of a notice covering security in after-acquired assets, or circulating funds of assets, for example inventory and receivables.

39. Grantor-based indexing greatly liberates the registration process. Secured creditors can publicize a security right in all of a grantor's present and after-acquired movable property, or in generic categories, through a single one-time registration. They need not worry about updating the record every time the grantor acquires a new item within the generic category set out in the notice.

40. Grantor-based indexing has one drawback. If the encumbered assets become the object of unauthorized successive transfers, prospective secured creditors and buyers cannot protect themselves by conducting a search according to the name of the immediate apparent owner. Because the system is grantor-indexed, the search will not disclose a security right granted by a predecessor in title.

41. A partial solution to this problem would be to require asset-based indexing for particularly high-value assets for which reliable numerical identifiers exist, for example, road vehicles, boats, motor homes, trailers, aircraft, and so forth. Although specific asset identification limits the ability to use a single notice to publicize security in after-acquired assets, it is practically necessary only for capital assets used in the grantor's business (and consumer assets used for personal purposes to

the extent these are covered by the registry). In cases where the assets are held by the grantor as inventory, a buyer in the ordinary course of business will take free of the security right in any event.

42. An alternative or complementary approach would be to require secured creditors who find out about a transfer by the grantor to add the transferee as an additional grantor on the registered notice so as to avoid subordination to intervening third party claimants. Alternatively, protection might be extended to all intervening buyers, or even all intervening third parties, even where the secured creditor has no knowledge of the debtor's unauthorized disposition (see also A/CN.9/WG.VI/WP.9/Add.3, para. 40).

c. Content of registered notice

i. Identification of grantor

43. Since grantor identity is the usual means by which notices of security are retrieved, registrants and searchers require guidance on the correct mode of identification. The grantor's name and address is the most common criterion.

44. For corporate grantors and other legal persons, the correct name can usually be verified by consulting the public record of corporate and commercial entities maintained by most States. If the information in this record and in the secured transactions registry is stored in electronic form, it may be possible to provide a common gateway to both records to simplify the verification process.

45. For individual grantors, verification of the correct name is a little more challenging. There may be inconsistencies between the grantor's popular and formal birth names, or between the names that appear on different identity documents. Name changes may have occurred since birth as a consequence of deliberate choice or a change in marital status. The provision of explicit legislative guidance to deal with these various contingencies ensures that registrants and searchers are operating according to the same criteria. For example, the regulations or administrative rules might specify a hierarchy of official sources, beginning with the name that appears on the grantor's birth certificate, and then referencing other sources (for example, a passport or driver's licence) in situations where there is no official birth record or it is inaccessible.

46. If more than one grantor shares the same name, the provision of the grantor's address will often resolve the identity issue for searchers. In States where many individuals share the same name, it may be useful to require supplementary information, such as the grantor's birth date. If a State has adopted a numerical identifier for its citizens, this can also be used, subject to privacy concerns, and subject to prescribing an alternative identifier for grantors who are non-nationals.

47. The impact of an error in the grantor's name on the legal validity of a notice depends on the organizational logic of the particular registry system. For instance, some electronic records are programmed to disclose only exact matches between the name entered by the searcher and the names appearing in the database. In such a system, any error will nullify the registration because it will render the notice irretrievable by searchers using the correct name of the grantor. In other systems, it may be possible to also retrieve close matches in which event the registered data may well turn up on a search using the correct identifier notwithstanding the entry

error. Whether the error nonetheless invalidates the registration depends on the particular case. A useful flexible test would be to treat the error as fatal only if the information disclosed on the notice would mislead a reasonable searcher.

ii. Identification of secured creditor

48. Entry of the name and address of the secured creditor or the secured creditor's representative on the registered notice enables third parties to contact the secured creditor if necessary and ensures that a person who later claims a priority benefit based on the notice is the person entitled to do so. The rules used for determining the correct name of a grantor can also be applied to secured creditors. However, the name of the secured creditor is not an indexing criterion. Consequently, registration errors do not pose the same risk of misleading third party searchers so as to nullify the notice.

iii. Description of encumbered assets

49. There is no absolute necessity to require a notice of a security right to include a description of the encumbered assets. However, the absence of a description would hamper the ability of a grantor to sell, or grant security in, assets that remain unencumbered. Prospective buyers and secured creditors would require some form of protection (for example, a release from the secured creditor) before entering into transactions involving any of the grantor's assets. The absence of a description would also diminish the value of the notice for insolvency administrators and judgement enforcement creditors.

50. For these reasons, a description of the encumbered assets is normally required. In a grantor-indexed system, there is no need to require a specific item-by-item description. The information needs of searchers are sufficiently served by a generic description (e.g. all tangible assets, all receivables) or even a super-generic description (e.g. all present and after-acquired movables). Indeed, generic description is necessary to ensure the efficient publicity of a security right granted in after-acquired assets, and in circulating funds or universalities of assets (e.g. "all claims" or "all inventory").

51. A more difficult question is whether the notice need only indicate the generic nature of the encumbered assets (e.g. tangible movables), even if the security right is in fact limited to a specific item (e.g. a single automobile), or whether the description should have to conform to the actual range of assets covered by the background security documentation.

52. The first approach simplifies the registration process and reduces the risk of descriptive error. It also permits the parties to amend their security agreement to add new assets within the same generic category without the need to make a further registration. On the other hand, this approach may complicate grantor access to financing against the unencumbered portion of the described assets. Since priority dates from the time of registration, subsequent buyers and secured creditors will require an explicit waiver or discharge to protect them against the risk that the grantor may later expand the actual scope of the assets covered by the initial security agreement.

iv. Maximum value of secured obligation

53. A further question is whether the notice must disclose the monetary value of the secured obligation. It is not desirable to require the actual or intended value to be set out because this would interfere with the flexibility of line of credit and instalment financing. However, secured creditors could be required to specify the maximum amount to be secured by the security right. This approach would facilitate the grantor's ability to use the residual value of assets subject to a broad security right to secure further financing from other secured creditors. On the other hand, the first secured creditor to take a general security right over the grantor's assets is typically the cheapest and most available source of credit. In addition, the value of imposing such a requirement would be lost if inflated estimates were routinely filed.

d. Access to more detailed information

54. Prospective buyers and secured creditors can generally deal with the priority risk presented by a registered notice without having to investigate further. They can refuse to deal further with the grantor, or obtain a release or subordination agreement from the registered secured creditor, or require the grantor to bring about a discharge of the registration (in cases where the registration does not represent a charge or where a new secured creditor is prepared to advance sufficient funds to pay out the prior registered secured creditor).

55. Third parties in the position of unsecured creditors and insolvency representatives, along with co-owners of the encumbered assets, are in a somewhat different position. They already have an existing or potential claim against the encumbered assets. However, the value of that claim can be assessed only by access to off-record evidence of the security agreement and the current amount of the outstanding obligation. Since the grantor of the security right may not be a reliable or cooperative source of this information, it may be desirable to impose a legal obligation on secured creditors to directly respond to a demand by third parties with a legitimate interest for further details within a reasonable time.

e. Duration of registration

56. The duration of secured financing relationships can vary considerably. The necessary flexibility can be accommodated in one of two ways. The first is to allow registrants to self-select the desired term of the registration with a right to file renewals. The second is to set a universal fixed term (e.g. five years), also accompanied by a right to file renewals.

57. In medium- and long-term financings, the first approach lessens the risk for secured creditors of a loss of priority for failure to renew in time. In short-term arrangements, the second approach reduces the risk for grantors that secured creditors will register for an inflated term out of an excess of caution.

58. Regardless of which approach is adopted, it is necessary from the perspective of the grantor to ensure that notices are expunged from the record within a reasonable period after the secured obligation is satisfied. Possible solutions include the imposition of a financial penalty on secured creditors who fail to register a timely discharge combined with the establishment of a summary administrative procedure for compelling discharge if the secured creditor fails to respond to a justified demand to do so by the grantor. As an added incentive to timely action, it

may be desirable to give secured creditors the right to register a discharge free of charge.

f. Administrative issues

i. Technological considerations

59. If the registry records are organized on a regional or district basis, complicated rules are needed to determine the appropriate registration venue and to deal with the consequences of a relocation of the assets or the grantor. On the other hand, a single national registry creates inequalities of access. Computerization of the registry data base resolves the problem by enabling all registrations to be entered into a single central record while also allowing for remote registration and searching.

60. An electronic database can support a fully electronic registration system, in which clients have direct computer access to the electronic data base for both registration and searching. This significantly reduces the costs of operation and maintenance of the system. It also enhances the efficiency of the registration process by putting direct control over the timing of entry into the hands of the registering party, and eliminating any time lags between submission of a notice and the actual entry of the information contained in the notice into the database. Perhaps most importantly, a fully electronic system places all responsibility for accurate data entry on registrant and searchers, thereby minimizing staffing and operational costs.

61. Ultimately, the optimal extent of computerization depends on the level of computer literacy among the registry client base, the reliability of existing communications infrastructure, and on an assessment of whether expected revenues will be sufficient to recover the initial capital costs of construction within a reasonable period. The overall objective is to make the registration and searching process as simple, transparent and accessible as possible within the context of the particular State.

ii. Liability for system error

62. If the system is exclusively electronic, there is no risk of human error on the part of the registry office at either the registration or searching stages. The responsibility is cast on the registrants and searchers. As for the risk of system breakdown, the consequences can usually be alleviated by prompt notification of clients and by extending any time periods that might have run out during the breakdown period. To the extent input of data and the entry of searches is carried out by registry staff, the risk of human error in transposing and retrieving data is present although this too can be alleviated by establishing electronic edit checks and ensuring the timely return to the client of a copy of the registration data or search result.

63. Whatever the design of the system, guidance needs to be given concerning the responsibility, and the limits of responsibility for registry staff or registry system error. One compromise solution would be to allocate a portion of the registry revenues to a mandatory compensation fund and to impose an upper limit on the amount of compensation for any single incident.

64. Assuming a compensation claim is available, further guidance is needed on who carries the risk of error as between registrants and third party searchers. In

resolving this issue, the rules might, for example, provide that an indexing error on the part of registry staff does not prejudice the publicized status of a security right except as against secured creditors or purchasers who can positively establish that they searched and suffered actual damage as a result of acting to their detriment on the misleading information contained in the record.

iii. Registration fees

65. High registration and search fees designed to raise revenue rather than support the cost of the system are tantamount to a tax, ultimately borne by grantors, on secured transactions. To encourage access to secured credit at a reasonable cost, it is critical for the success of the system to set fees at a nominal level that encourages use of the system, while still enabling the system to recover its capital and operational costs within a reasonable time.

iv. Privacy and confidentiality considerations

66. A notice-based registration system enhances the confidentiality of the grantor's and secured creditor's relationship by limiting the level of detail about the parties' relationship that appears on the public record.

67. The topic of confidentiality raises the issue of whether the system should be organized to facilitate searching against the name of the secured creditor as well as the grantor. While the quantity and content of notices filed by a particular financial institution or other creditor entity is not relevant to the legal mission of the registry, this kind of information may have market value as a source of a competitor's customer lists or for companies seeking to market related financial or other products. Although the additional revenues would be attractive, the retrieval and sale of this kind of bulk information is likely to damage trust in the system and may well violate privacy laws.

g. Priority effects

i. Advance registration

68. The establishment of a secured transactions registry enables competing registered security rights in the same encumbered asset to be resolved according to a general first-to-register rule. The exceptions to this general rule are dealt with in detail in the chapter on priority (see A/CN.9/WG.VI/WP.9/Add.3, paras. 12-17). However, an issue that is relevant at this stage is whether a secured creditor should be permitted to file a notice of security in advance of the actual conclusion of the security agreement (a notion similar to the pre-notation of a mortgage in a land registry).

69. Advance filing enables a secured creditor to establish its ranking against other secured creditors without having to check for further filings before advancing funds. Advance filing also avoids the risk of nullification of the registration in cases where the underlying security agreement happens to have been technically deficient at the point of registration but is later rectified, or where there are factual uncertainties as to the precise time when the security agreement was concluded.

70. From the perspective of the grantor, adequate protection from the risk that no security agreement ultimately emerges can be assured through the same measures

used in the case of unauthorized registrations (i.e. by requiring that the named grantor be informed of any registration and by establishing a summary administrative procedure to enable the grantor to compel a discharge if the identified secured creditor fails to act within a reasonable time).

ii. Qualifications on priority

71. It was pointed out in earlier parts of this chapter that registration may not always be the optimal mode of publicity from the point of view of priority, as for instance, where the encumbered assets consist of investment property publicized by control, or where they are subject to a title registry or title certificate system (see paras. 17-19 and 26-33).

72. In addition, while registration may be a precondition to the effectiveness of a security right, a registered security right is not necessarily effective against all categories of third parties. For instance, a purchaser of inventory sold in the ordinary course of the seller's business normally takes free of any security right granted by the seller. Similarly, the existence of a security right typically does not impair the rights acquired by a lessee or licensee of encumbered assets subject to a registered security right. Finally, third parties who acquire possession of cash or negotiable assets for value in the ordinary course of business are usually protected from a prior registered security right.

73. These rules are addressed in detail in the chapter on priority (see A/CN.9/WG.VI/WP.9/Add.3, paras. 34-43). The important point for the purposes of this chapter is that the registration of a notice of security does not interfere with the freedom of third parties to engage in ordinary-course-of-business commercial transactions with the grantor involving the encumbered assets without any worry about having to search the secured transactions registry or indeed being bound by a registered security right of which they happen to be aware.

h. Registration and enforcement

74. In some legal systems, a secured creditor is required to register a notice of default and enforcement before being entitled to exercise its enforcement remedies against the encumbered assets. In other legal systems, registration is not a precondition 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 interest in the encumbered assets of the initiation of enforcement action. If this burden is imposed on the secured creditor directly, registration may not be needed. If the burden is instead placed on the registrar or some other public official, then registration is needed in order to trigger the relevant official's obligation to notify other registered claimants.

75. Advance registration of intended enforcement action may help to 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 already has been initiated by any of them. While some level of inter-creditor communication is invariably needed in practice in order to ensure adequate coordination, registration would at least enable creditors to focus their inquiry efforts (see A/CN.9/WG.VI/WP.9/Add.5, paras. …).

i. Extension of registry to non-security transactions

i. Title and similar devices

76. A security right may sometimes be granted through the device of a transfer of title to the secured creditor under a "sale" or "trust" on the understanding that title is to be reconveyed on satisfaction of a credit obligation owed by the buyer or beneficiary (see A/CN.9/WG.VI/WP.9/Add.1, paras. 29-45). Since the rationale for requiring publicity applies regardless of the form of the transaction, legal systems with modern, comprehensive secured transactions laws adopt a broad approach that sweeps in all transactions that function to secure an obligation owed to a creditor.

77. However, secured transactions are not the only transactions that create problems of publicity. The existence of any property right poses risk for third parties dealing with the apparent owner. Moreover, these other rights may devalue the priority status of a security right to the extent they are not publicized.

78. One means of alleviating these problems is to extend the same publicity requirement that applies to security rights to all commercial transactions in movables that are likely to create significant publicity concerns. As a practical matter, this would involve making registration of a notice in the secured transactions registry a precondition to the third party effectiveness of the transaction.

79. The most obvious categories of common place transactions that might qualify for inclusion are:

- A sale of tangible assets subject to retention of title as security for the purchase price;
- A lease of tangible assets of significant duration (e.g. one year);
- An outright assignment of monetary claims;
- A consignment for sale of tangible assets;
- A non-consensual security right in movable assets created by operation of law.

80. Whether the priority rules that apply to registered security rights should also apply to these transactions is a more complex question. The first-to-register rule has obvious utility where an assignment of claims comes into competition with a security right granted in the same claims. However, in the case of a lease, a consignment, or a retention of title sale, temporal priority ordering has to be qualified in order to preserve the lessor's, the seller's or the consignor's title as against prior registered security rights, perhaps subject to the requirement that registration be effected within a set time period after the transaction. These details are taken up in the chapter on priority (see A/CN.9/WG.VI/WP.9/Add.3, paras. 21-33).

81. The extension of the publicity and priority rules applicable to secured transactions to other commercial dealings is reflected at the international level in two conventions. The first is the Convention on International Interests in Mobile Equipment which extends the international registry contemplated by the Convention beyond charges to also include retention of title agreements in favour of sellers and aircraft leasing arrangements. The second is the United Nations Assignment Convention under which the choice of law rules governing issues of publicity and

priority apply to both the outright assignment and the grant of security in receivables.

ii. Judgement creditors

82. A judgement creditor may be authorized to register a notice of judgement in the secured transactions registry, with registration automatically creating the priority equivalent of a general security right against the judgement debtor's movables. This approach might indirectly promote the prompt voluntary satisfaction of judgement debts since the effect would be to impede the judgement debtor from selling or granting security to third parties without having first paid the judgement debt and having the registration discharged.

83. If this approach is adopted, it is necessary to ensure that the judgement creditor's right does not conflict with insolvency policies requiring equality of treatment among the grantor's unsecured creditors. This can be resolved by a rule in which the insolvency representative automatically acquires the right to any pre-existing judgement right for the benefit of all creditors (perhaps subject to a special privilege in favour of the registered judgement creditor to compensate for registration expenses and efforts; see also A/CN.9/WG.VI/WP.9/Add.3, paras. 44-49).

7. Other modes of publicity

84. Some legal systems substitute more limited notice venues for a public registry (for instance, entry of a notice in the grantor's own books, or in the books of a notary or court official, or in newspapers in the grantor's locale, or in some government journal). Although certain of these notice venues sufficiently address concerns with fraudulent antedating, in comparison to a comprehensive secured transactions registry, they lack the permanence and ease of public accessibility needed to adequately protect third parties.

85. Some legal systems require publicity in the form of affixation of a plaque or other form of physical notice to the encumbered asset. The reliability of such a publicity mechanism is limited in view of the potential for abuse by the grantor. However, in some markets, the specialized nature of the asset and industry practice may make this form of symbolic possession acceptable (e.g. branding of cattle).

8. Effectiveness of unpublicized security rights

a. Against the grantor

86. Publicity is concerned with the third party effects of security rights. It would seem to follow that publicity is unnecessary to constitute an effective security right as between the secured creditor and the grantor.

87. In any event, for most issues involving the immediate parties, the relationship between publicity and the creation of a security right is not practically relevant. After all, the secured creditor has contractual rights against the relevant assets from the moment that the security agreement is concluded. So long as the grantor is the only other party involved, it does not matter whether the secured creditor's rights are characterized as proprietary or personal in nature.

b. Against third parties

i. General considerations

88. There are three possible responses to determining the legal efficacy of an unpublicized security right against third parties. The first is to treat security rights as effective as soon as they are created subject to special protection for specified classes of third parties, for example those who rely to their detriment on the grantor's apparent ownership. The second is to make publicity an absolute precondition to the third-party effects of security rights. The third is to require publicity only as against specified categories of third-party rights.

89. In light of the diversity of potential responses, it may be more useful to examine the issue of the effectiveness of an unpublicized security in relation to each of the principal categories of competing claimants.

ii. Competing secured creditors

90. If non-possessory security rights are allowed to take effect against competing secured creditors without publicity, the direct costs of secured transactions are minimized and there is no need to invest in the establishment of a general secured transactions registry. On the other hand, publicity enables all prospective secured creditors to more accurately assess their priority risk. In its absence, they must rely on the assurances of the grantor, and their own inquiries and perceptions. This additional investigatory burden may impede access to credit by prospective borrowers without an established credit record, and restrict credit market competition.

91. If publicity is required, there is the further question of whether actual knowledge compensates for lack of publicity. If so, an unpublicized security right would trump a publicized security right acquired with knowledge of a prior unpublicized security right. This potentially undermines the certainty and predictability created by a general publicity rule and the value of the first-to-register rule in the context of competing security rights publicized by registration of a notice in a secured transactions registry. Moreover, there is no unfairness or bad faith inherent in requiring the first in time creditor to bear the consequences of failing to effect timely publicity.

iii. Transferees of encumbered assets

92. By virtue of the proprietary character of security rights, a secured creditor is presumptively entitled to follow the assets into the hands of a third-party buyer who acquires title under an unauthorized sale by the grantor (*droit de suite*). In the absence of a publicity requirement, preservation of the secured creditor's *droit de suite* must be balanced against the need to protect the certainty of sales of movables. This may require a rule protecting the title acquired by buyers who take without actual or presumptive knowledge of an unpublicized security right. A publicity requirement dispenses with the need to choose between these two values. Buyers can protect themselves in advance of the purchase by verifying the grantor's possession or control of the encumbered assets and by conducting a search of the secured transactions registry or title registry as the case may be (and buyers in the ordinary course of business or buyers in good faith and possibly other

unsophisticated buyers may be exempted from the obligation to register or search; see A/CN.9/WG.VI/WP.9/Add.3, paras. 34-43).

93. There is the further question of whether an unpublicized security right should be effective against a buyer who acquires an encumbered asset with actual knowledge. Priority rules that turn on actual knowledge require a fact-specific investigation of a subjective state of mind, particularly difficult in the context of corporations and other artificial persons. As such, they complicate dispute resolution. A compromise solution may be to treat an unpublicized security right as ineffective only as against buyers who acquire both title and possession of the encumbered assets. This would amount to treating the buyer's possession as a pre-emptive act of publicity.

iv. Donees

94. The position of a donee of encumbered assets is somewhat different than that of a buyer or other transferee for value. Because the donee has not parted with value, there is no objective evidence of detrimental reliance on the grantor's apparently unencumbered ownership. For this reason, there may be no harm in requiring the donee to respect the prior grant of security regardless of publicity. Against this, one must balance the additional dispute resolution resources involved in settling the status of a transferee and dealing with the possible complications created by a change of position on the part of the donee subsequent to the gift.

v. Insolvency representatives

95. In the absence of a publicity requirement, a security right is normally effective against the grantor's insolvency representative or judgement creditors, provided it is granted before insolvency proceedings are initiated (or before any pre-insolvency suspect period begins to run). This is sometimes justified on the basis that the unsecured creditors did not rely on the grantor's unencumbered ownership in extending credit. Even if they did, the very act of having extended credit without taking security implies an acceptance of the risk of subordination to the claims of subsequent secured creditors.

96. On the other hand, requiring publicity in advance of insolvency proceedings offers protection against the risk of fraudulent antedating of security instruments. Even more significantly, it reduces the cost of the insolvency by giving the insolvency representative an efficient means of ascertaining which security rights are presumptively effective (see A/CN.9/WG.VI/WP.9/Add.6, para. 2). Outside of formal insolvency, publicity likewise enables judgement creditors to determine in advance of initiating costly execution action whether the debtor's assets are already encumbered by security (see A/CN.9/WG.VI/WP.9/Add.6, para. 49).

B. Summary and recommendations

97. Removing the encumbered assets from the possession of the grantor is the traditional mode of publicizing the grant of a security right in movable assets. Although dispossession does not positively communicate that the absent assets are subject to a security right, it does alert third parties to the risk that the grantor no longer has unencumbered title. However, to achieve this result, dispossession must

be real, not fictive. If the grantor retains apparent ownership, third parties are not protected.

98. Physical dispossession is not feasible where the encumbered assets consist of intangible obligations owed to the grantor by a third party. However, the functional equivalent of dispossession can be obtained by transferring legal control over the performance obligation owed by the third party to the secured creditor. For example, control over a deposit account held with a financial institution or insurance company can be transferred by placing the account in the name of the secured creditor or obtaining the agreement of the depository institution to respond to directions by the secured creditor.

99. For monetary claims, a secured creditor can generally obtain legal control by notifying the third party obligated on the claim to make payment directly to the secured creditor. Nonetheless, it may not be desirable to recognize this as a sufficient act of publicity. Such a rule would require prospective secured creditors, prospective assignees, and other third parties to find out whether notification had been made by a prior secured creditor in order to assess their priority risk. The inquiry burden would impede secured financing based on the grantor's general fund of present and after-acquired trade receivables.

100. Physical dispossession or the transfer of control is not workable if the grantor needs to retain use of the encumbered assets in the course of its business. Many States have established specialized title certificate or title registry systems for limited categories of high value assets, such as road vehicles, ships, aircraft and patents. Where these exist, they offer an acceptable alternative mode of publicity since third parties dealing with the grantor can protect themselves by conducting a search of the title registry, or examining the notations on the title certificate.

101. Title- or asset-based modes of publicity are not practical for security rights in generic funds of present and after-acquired assets, such as inventory, or rights in specific assets for which title-tracking is not economically worthwhile. The only feasible publicity solution here lies in the establishment of a secured transactions registry in which a notice of the security right can be filed by reference to the name of the grantor of the security right.

102. In the absence of a comprehensive secured transactions registry, there is no point in requiring publicity as a precondition to the third party effectiveness of a security right. Assuming the property rules for constituting an effective security right are satisfied, the secured creditor's rights against third parties would instead by assessed by reference to priority rules based on the policy question of which categories of third party claimants ought to take free of a security right of which they have no knowledge or means of knowledge.

103. Consequently, States interested in introducing a comprehensive secured transactions registry with a view to developing competitive financial markets should establish a comprehensive secured transactions registry for publicizing notices of security rights to enable potential secured creditors and third parties to assess their priority risk with greater certainty and predictability. If so, priority rules should address a number of questions, including:

(a) Whether registration confers superior priority in a competition with a competing security right that was publicized by dispossession or control;

(b) Whether publicity by way of dispossession or control confers superior priority as against competing buyers and secured creditors for some categories of encumbered assets, for example, negotiable instruments in the interest of preserving negotiability;

(c) If the encumbered assets are covered by a specialized title registry or by notation on a title certificate, whether competing security rights and other third party rights that are publicized through these regimes trump a security right publicized by dispossession or by registration in a general secured transactions registry;

(d) In the case of a grantor-indexed registry, what is the most appropriate means of addressing the particular publicity concerns faced by a remote transferee of assets that are the subject of a registered notice, that is, one who acquires the encumbered assets from a successor in title to the grantor. If the secured creditor has not amended the notice to add the name of the transferor, the question arises whether the security right should nonetheless be effective against a transferee without actual knowledge. Alternatively, the question is whether specific asset-based registration should be a precondition of the third party effectiveness of a security right in encumbered assets that have a relatively high value and for which an active resale market exists (e.g. automobiles, motor boats, motor homes;

(e) What are the requirements for a legally effective registered notice. In particular: what constitutes an adequate identification of the grantor and an adequate description of the encumbered assets; whether the maximum value of the obligation capable of being secured by the encumbered assets should be specified in the registered notice; whether the effective duration of a registration, subject to timely renewal, should be determined by reference to the term selected in the registered notice or by reference to a standard term established by law; whether registration in advance of the actual conclusion of any security agreement is permissible; whether a single registration can publicize security granted under successive security agreements between the same parties and covering the same assets;

(f) What techniques are available to protect a grantor from unauthorized or erroneous registrations;

(g) Whether certain categories of third parties are entitled to demand further information about the current status and details of the financing arrangement from the secured creditor directly, notably, co-owners, unsecured judgement creditors, and the grantor's insolvency representative;

(h) What is the optimal policy on design and operational issues, in particular, the establishment of registration and search fees and extent of computerization of the system;

(i) Whether registration is a precondition to the third party effectiveness of other non-possessory dealings in movable assets even though they do not secure performance of an obligation, for example, a long-term lease of tangible movables, a sale subject to retention of title pending payment of the price, an outright assignment of intangible claims.