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Draft legislative guide on secured transactions

Note by the Secretariat*

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* This document is submitted later than the required ten weeks prior to the start of the meeting because of the need to complete consultations and to finalize consequent amendments.

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I. Introduction

A. Purpose

1. The purpose of this Guide is to assist States in the development of modern secured transactions laws with a view to promoting the availability of low-cost secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.

2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (particularly small and medium-size enterprises), and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making low-cost consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see UNCITRAL Legislative Guide on Insolvency Law).

3. The Guide seeks to rise above differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable, yet limited, costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.

5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of payment in the event of non-payment of the secured obligation. As the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. On the other hand, in States

that do not have efficient and effective laws, where creditors perceive the legal risks associated with credit transactions to be high, the cost of credit increases as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime, or of an insolvency law regime under which security rights are recognized, has resulted in the virtual elimination of credit for small and medium-size commercial enterprises, as well as for consumers.

7. By aiding in the cultivation and growth of individual businesses, creating a legal regime that promotes secured credit can have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves a valuable economic benefit.

8. To best promote the availability of low-cost secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their property to the maximum extent possible to obtain credit. In this regard, the Guide adopts two of the most essential concepts of successful secured transactions laws, the concepts of priority and effectiveness against third parties. The concept of priority, which allows for the concurrent existence of security rights having different priority status in the same assets, makes it possible for a business to utilize the value of its assets to the maximum extent possible by obtaining secured credit from more than one creditor using the same assets as security with transparent rules allowing each creditor to know the priority of its security right. The concept of effectiveness against third parties, in the form of a system allowing, inter alia, the registration of a notice concerning security rights, is designed to promote legal certainty with regard to the relative priority status of creditors and thus to reduce the risks and costs associated with secured transactions.

B. Scope

9. The Guide deals with consensual security rights. However, it contains references to non-consensual rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.14/Add.1, paras. 56-61 and 82-85). The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of assets are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, both tangible and intangible, with the exception of assets specifically excluded.

10. Immovable property, securities and wages are types of asset that are subject to an outright exclusion. Immovable property (with the exception of fixtures, which are covered by the Guide and can be subjected to security rights) is excluded as it raises different issues and is subject to a special title registration system indexed by asset and not by grantor. In addition, the Guide does not cover security rights in securities as original encumbered assets because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. The substantive law issues relating to security

and other rights in securities held with an intermediary are dealt with in a draft Convention being prepared by the International Institute for the Unification of Private Law (Unidroit). The private international law issues with respect to that subject matter are not addressed in this Guide since they are dealt with in the Hague Convention on the Law applicable to Certain Rights in Respect of Securities (The Hague, December 2002). The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by Unidroit and the Hague Conference, as well as relevant texts prepared by UNCITRAL, such as the United Nations Convention on the Assignment of Receivables in International Trade (New York, December 2001; herein after referred to as "the United Nations Assignment Convention") and the UNCITRAL Legislative Guide on Insolvency Law.

[*Note to the Working Group: The Working Group may wish to note that, if it adopts a qualified exclusion of securities and immovable property (see A/CN.9/WG.VI/WP.26/Add.7, note to rec. 3 (g)), para. 10 would need to be revised. Similarly, if rec. 4 (d) is adopted, the commentary should include some explanation. Similar amendments may need to be made depending on the decisions of the Working Group on the issues raised in the notes to rec. 3 (d) and (f).*]

11. Security rights in wages are excluded based on the policy of protecting individual and family life. Any additional exclusions based on competing policy objectives should be limited in number and in scope, should be clearly stated in the law and should be adopted only after their potential benefit has been carefully weighed against the social and economic policy underlying the secured transactions law of promoting the availability of low-cost credit.

12. Some assets, such as ships, aircraft [and intellectual property rights] are in whole or in part subject to special laws. Security rights in such assets are not excluded but, in the case of any inconsistency between such a special law and secured transactions law, the special law (e.g. the special registration system) prevails.

13. In particular, the Guide does not address issues specific to security rights in intellectual property rights and it does not make recommendations concerning those issues. However, in developing its secured transactions law, a State should take account of the increasing importance and economic value of intellectual property assets to companies seeking to obtain low-cost secured credit. Subject to the limitations discussed in the following paragraph, the secured transactions law would apply to security interests in intellectual property rights.

14. When adopting a secured transaction regime, a State should take into account the particular characteristics of, and national laws applicable to, intellectual property, as well as the State's obligations under international intellectual property treaties, conventions and other international agreements. Accordingly, when implementing the recommendations of the Guide, a State should give careful consideration to situations in which the existing legal regime and characteristics of intellectual property are sufficiently unique as to justify the adjustment of those recommendations when the encumbered assets include intellectual property rights. If upon examination there is found to be a direct inconsistency between the State's intellectual property laws or obligations under intellectual property treaties, conventions and other international agreements, in particular insofar as they

establish a rule for the creation, effectiveness against third parties, priority or enforcement of security rights in intellectual property, then the State's secured transactions law should provide that the intellectual property laws and obligations will govern such issues to the extent of any inconsistency.

15. The Guide stresses the need to enable a grantor to create security rights not only in its existing assets but also in its future assets (i.e. assets acquired or created after the conclusion of the security agreement), without requiring the grantor or secured creditor to execute any additional documents or to take any additional action at the time such assets are acquired or created. This approach is consistent, for example, with the United Nations Assignment Convention, which provides for the creation of security rights in future receivables without requiring any additional steps to be taken. In addition, the Guide recommends recognition of a security right in all existing and future assets of a business grantor through a single security agreement such as already exists in some legal systems as an "enterprise mortgage" or as a combination of fixed and floating charges.

16. The Guide also recommends that a broad range of obligations, monetary and non-monetary, may be secured and that both physical and legal persons may be parties to a secured transaction, including consumers, subject to consumer-protection laws. In addition, the Guide is intended to cover a broad range of transactions that serve security functions, including those related to possessory and non-possessory security rights, as well as transactions not denominated as secured transactions (such as retention of title, transfer of title for security purposes, assignment of receivables for security purposes, financial leases, and sale and leaseback transactions and the like).

17. The legal regime envisaged in the Guide is a purely domestic regime. The recommendations of the Guide are addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the recognition of security rights and title-based security devices, such as retention of title and financial leases, effectively created in other jurisdictions. This would represent a marked improvement for the holders of those rights over the laws currently in effect in many States, under which such rights often are lost once an encumbered asset is transported across national borders, and would go far toward encouraging creditors to extend credit in cross-border transactions (see A/CN.9/WG.VI/WP.14/Add.4, paras. 21-25).

18. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, buyers and other transferees, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that all creditors will accept such a balanced approach, and will thereby be encouraged to extend credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately realize the economic value of the encumbered assets. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many

forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since this matter does not lend itself to unification.

19. In the same spirit, the Guide also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. Another concern is the potential ability of a secured creditor to exercise influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. Yet another concern is that in some cases secured creditors may take most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, some of whom are not in a position to bargain for a security right in those assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, suggests solutions.

20. The Guide builds on the work of UNCITRAL and other organizations. Such work includes: the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD General principles of a modern secured transactions law, completed in 1997; the OHADA Uniform Act Organizing Securities, prepared in 1997; the study on Secured Transactions Law Reform in Asia, prepared by the Asian Development Bank in 2000; the United Nations Assignment Convention, adopted in 2001; the Convention on International Interests in Mobile Equipment, adopted in 2001, and the relevant protocols; the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted in 2001; the Organization of American States (OAS) Model Inter-American Law on Secured Transactions, prepared in 2002; the UNCITRAL Legislative Guide on Insolvency Law, completed in 2004; [the UNIDROIT Convention on Substantive Rules regarding Intermediated Securities; and […]].

C. Terminology

21. This Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given to the term may differ. This approach is taken to provide readers with a common vocabulary and conceptual framework and to encourage harmonization of the law governing security rights. The following paragraphs therefore identify the principal terms used and the core meaning given to them in this Guide. The meaning of those terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms (as is the case, for example, with the insolvency and the acquisition finance chapters). "Or" is not intended to be exclusive; use of the singular also includes the plural and vice versa; "include" and "including" are not intended to indicate an exhaustive list; "may" indicates permission and "should" indicates instruction; and "such as" and "for example" are to be interpreted in the same manner as "include" or "including". ["Creditors" should be interpreted as including both the creditors in the forum State and foreign creditors, unless otherwise specified.] References to "person" should be interpreted as including both natural and legal persons, unless otherwise specified. The term "law" throughout the draft

Guide is intended to include both statutory and non-statutory law. The phrase “law governing negotiable instruments” or similar expression encompasses all law that applies to negotiable instruments, including not only negotiable instrument law but also contract and other law that might be applicable.

(a) “Security right” means a consensual property right in movable property and attachments that secure payment or other performance of one or more obligations, regardless of whether the parties have designated it as a security right. With respect to receivables, security right also means an outright transfer of a receivable, as well as a transfer by way of security. It includes acquisition security rights and non-acquisition security rights. [*See A/CN.9/WG.VI/WP.24/Add.5.*] References to a “security right” in this Guide also refer to the “right of an assignee”.

(b) “Acquisition security right” means a security right in an asset that secures the obligation to pay any unpaid portion of the purchase price of the asset or an obligation incurred to enable the grantor to acquire the asset. Acquisition security rights include those that are denominated as security rights, as well as rights acquired under retention-of-title sales, hire and-purchase transactions, financial leases and purchase-money lending transactions. “Grantor” of an acquisition security right includes a buyer, financial lessee or grantor in a purchase-money lending transaction. “Acquisition financier” means the secured creditor with an acquisition security right and includes a retention-of-title seller, financial lessor or purchase-money lender. [*See A/CN.9/WG.VI/WP.24/Add.5*]

(c) “Secured obligation” means the obligation secured by a security right.

(d) “Secured creditor” means a creditor that has a security right. References to the “secured creditor” in this Guide also refer to the “assignee”. [*See A/CN.9/WG.VI/WP.26*]

(e) “Debtor” means a person that owes performance of the secured obligation [and includes secondary obligors, such as guarantors of a secured obligation]. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor).

(f) “Grantor” means a person that creates a security right in one or more of its assets in favour of a secured creditor to secure either its own obligation or that of another person (see debtor of the receivable). References to the “grantor” in this Guide also refer to the “assignor”.

[*Note to the Working Group: The Working Group may wish to note that the second sentence in the definitions of “security right, “secured creditor” and “grantor” is intended to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided.*]

(g) “Security agreement” means an agreement between a grantor and a creditor, in whatever form or terminology, that creates a security right.

(h) “Encumbered asset” means property that is subject to a security right. The property may be tangible or intangible. Each of these two general types of property includes various categories, some of which fall within particular defined terms used in the Guide.

(i) "Tangibles" means all forms of corporeal movable property. Among the categories of tangibles are inventory, equipment, attachments, negotiable instruments and negotiable documents.

(j) "Inventory" means a stock of tangibles held for sale or lease in the ordinary course of business and also raw and semi-processed materials (work-in-process).

(k) "Equipment" means tangibles used by a person in the operation of its business.

(l) "Attachments to immovable property" means tangibles that are so physically attached to immovable property as to be treated as immovable property without however losing their identity as movables under the law of the State where the immovable property is located. [*See A/CN.9/WG.VI/WP.26/Add.4*]

(m) "Attachments to movable property" means tangibles that are so physically attached to other movable property [as to be treated as part of that movable property], without however losing their identity under law other than this law. [*See A/CN.9/WG.VI/WP.26/Add.4*]

(n) "Mass or product" means tangibles other than money that are so physically associated or united with each other that they lose their separate identity under law other than this law. [*See A/CN.9/WG.VI/WP.26/Add.4*]

(o) "Intangibles" means all forms of movable property other than tangibles. Among the categories of intangibles are claims and receivables.

(p) "Receivable" means a [contractual] right to the payment of a monetary obligation excluding rights to payment evidenced by a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account.

[*Note to the Working Group: The Working Group may wish to recall that, at its tenth session, it decided that non-contractual receivables should be covered (see A/CN.9/603, para. 36). This result may be achieved by limiting the definition of receivables to contractual receivables and clarifying in the commentary that the general recommendations apply to non-contractual receivables. Alternatively, the definition of "receivable" might be retained as is but the definition of "original contract" might need to be revised to address the sources of non-contractual receivables. In addition, new recommendations might need to be added to ensure that: (i) recommendations 13 and 14 (dealing with statutory limitations on assignability) do not affect statutory limitations to the assignability of non-contractual receivables and (ii) that recommendations 16 bis and ter (dealing with representations of the assignor) do not apply to security rights in non-contractual receivables.*]

(q) "Assignment" means the creation of a security right in a receivable, including an outright transfer of a receivable. [*See article 2 (a) of the United Nations Assignment Convention.*]

[*Note to the Working Group: The Working Group may wish to note that the commentary will explain that the creation of a security right in a receivable includes an outright transfer of receivables by way of security, which is treated in the draft Guide as a security right.*]

(r) "Assignor" means the person that makes an assignment of a receivable. [*See article 2 (a) of the United Nations Assignment Convention.*]

(s) "Assignee" means the person to which an assignment of a receivable is made. [*See article 2 (a) of the United Nations Assignment Convention.*]

(t) "Subsequent assignment" means an assignment by the initial or any other assignee. In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee. [*See article 2 (b) of the United Nations Assignment Convention.*]

(u) "Debtor of the receivable" means a person liable for payment of a receivable. "Debtor of the receivable" includes a guarantor, as an accessory guarantee is a receivable. [*See article 2 (a) of the United Nations Assignment Convention.*]

[*Note to the Working Group: The Working Group may wish to recall that, at its tenth session, it agreed that the word "account" should be deleted from the references to "the account debtor". It is suggested that the term "account debtor" should be replaced by the term "debtor of the receivable". This approach would result in avoiding confusion with the debtor of the secured obligation, as well as a major change to the whole draft Guide that may not be substantively correct (as the word "debtor" should refer to the debtor of the secured obligation). In addition, this approach is not inconsistent with the United Nations Assignment Convention, in which reference was made to "the debtor" rather than to the debtor of the receivable, since, unlike the draft Guide which covers many types of asset, the Convention covers only receivables. If the Working Group approves this change, the references to the "account debtor" throughout the draft Guide will be revised to refer to "the debtor of the receivable".*]

(v) "Notification of the assignment" means a communication in writing that reasonably identifies the assigned receivable and the assignee. [*See article 5 (d) of the United Nations Assignment Convention*]. The writing requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference (see article 6 of the UNCITRAL Model Law on Electronic Commerce).

[*Note to the Working Group: The Working Group may wish to note that the definition of "notification of the assignment" includes the rule contained in recommendation 9 (see A/CN.9/WG.VI/WP.26/Add.7). The Working Group may wish to note that reference to writing is made only in the notification of the assignment and the notice of a security right, but not in the other notices referred to in the draft Guide (e.g. notice of intention to pursue extrajudicial enforcement).*

Depending on whether the reference to signature is retained in recommendation 7 the Working Group may wish to consider whether the rule contained in recommendation 10 (see A/CN.9/WG.VI/WP.26/Add.7) that "signature" includes electronic signature should be reflected in the definitions. The Working Group may wish to note that reference to a "signed writing" is made, apart from recommendation 7, in recommendation 21 dealing with waiver of defences of the debtor of the receivable.]

(w) "Original contract" in the context of an assignment means the contract between the assignor and debtor of the receivable from which the receivable arises. [*See article 5 (a) of the United Nations Assignment Convention.*]

[*Note to the Working Group: The Working Group may wish to note that the recommendations on receivables will make it clear that statutory limitations with respect to non-contractual receivables are not affected and the recommendation on representations of the assignor are not relevant with respect to statutory receivables (see A/CN.9/603, para. 36).*]

(x) "Negotiable instrument" means an instrument that embodies a right to payment, such as a cheque, bill of exchange or promissory note which satisfies the requirements for negotiability under the law governing negotiable instruments.

(y) "Negotiable document" means a document that embodies a right for delivery of tangibles, such as a warehouse receipt or a bill of lading, and satisfies the requirements for negotiability under the law governing negotiable documents.

(z) "Independent undertaking" means a letter of credit (commercial or standby), a confirmation of a letter of credit, an independent guarantee (demand, first demand, bank guarantee or counter-guarantee) or any other undertaking recognized as independent by law or practice rules, such as the United Nations Convention on Independent Guarantees and Standby Letters of Credit, the Uniform Customs and Practice for Documentary Credits, the International Standby Practices, and the Uniform Rules for Demand Guarantees.

(aa) "Proceeds under an independent undertaking" means the right to receive a payment due, a draft accepted or deferred payment or another item of value, in each case to be delivered by the guarantor/issuer honouring or by a nominated person giving value for, a draw under an independent undertaking. The term does not include[:] (i) the right to draw (i.e. to request payment) under an independent undertaking, or (ii) what is received upon honour of a drawing from the guarantor/issuer or nominated person or upon disposition of a right to drawing proceeds from an independent undertaking (i.e. the proceeds themselves).

[*Note to the Working Group: the commentary will explain that the definition refers to "proceeds under an independent undertaking" to be consistent with terminology generally used in independent undertaking law and practice. The term as used in this Guide means the right of the grantor as beneficiary of an independent undertaking to receive whatever payment or other value is given under the independent undertaking contingent upon the beneficiary's compliance with the terms and conditions of the independent undertaking. The term does not include the proceeds themselves, i.e. what is actually received upon honour of a drawing from the guarantor/issuer, confirmer or nominated person (a beneficiary's receipt of value from a negotiating bank should not be characterized as honour or disposition) or upon disposition of a right to proceeds under an independent undertaking.*

The term "proceeds under an independent undertaking" refers to a right to receive even though the term "proceeds" as used in independent undertaking law and practice may refer either to the right to receive or to whatever is received under the independent undertaking, and even though the term "proceeds" as used elsewhere in the draft Guide refers to whatever is received. The commentary will highlight the distinction between a security right in proceeds under an independent *undertaking (as an original encumbered asset) and the "proceeds" (a key concept of the draft Guide) of assets covered in the draft Guide. The Working Group will note that the reference to the "beneficiary-grantor" has been deleted as unnecessary. This is in line with the Guide's treatment of the term "receivable" (the draft Guide does not define "receivable" in terms of the grantor). Moreover, at the time of the grant, the grantor may not yet be a beneficiary; indeed, the independent undertaking may not even exist at that time. The question of who is entitled to receive payment is a matter of other law (in the context of receivables, for example, the Guide does not specify who is entitled to receive payment of the receivable).*]

(bb) "Guarantor/issuer" means a bank or other person that issues an independent undertaking.

(cc) "Confirmer" means a bank or other person that adds its own independent undertaking to that of the guarantor/issuer.

[*Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in line with article 6 (e) of the United Nations Guarantee and Standby Convention, a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer.*]

(dd) "Nominated person" means a bank or other person that is identified in an independent undertaking by name or type (e.g. "any bank in country X") as being nominated to give value, i.e. to purchase or pay upon presentation of documents, and that acts pursuant to that nomination.

(ee) A secured creditor has "control" with respect to proceeds under an independent undertaking: (i) automatically upon the creation of the security right if the guarantor/issuer, confirmer or nominated person is the secured creditor, or (ii) if the guarantor/issuer, confirmer or nominated person has made an acknowledgment in favour of the secured creditor. "Acknowledgment" with respect to proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a draw under an independent undertaking has, unilaterally or by agreement: (i) acknowledged or consented to (however evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the proceeds from an independent undertaking, or (ii) has obligated itself to pay or give value to the secured creditor upon a draw under an independent undertaking.

[*Note to the Working Group: The Working Group may wish to note that the commentary will include language that the definitions must be read together with all recommendations relating to independent undertakings (3 (d), 16, 25, 25 bis, 25 ter, 25 quater, 49, 62, 106, 138 and 138 bis).*]

(ff) "Bank account" means an account that is maintained by a bank into which funds may be deposited or credited. The term includes a chequing or other current account, as well as a savings or time-deposit account. The term does not include a claim against the bank arising under law governing negotiable instruments.

[*Note to the Working Group: The Working Group may wish to note that the commentary will explain that the right to payment of funds credited to a bank* *account covers a right to the payment of funds transferred into an internal account of the bank and not applied to any obligations owing to the bank. The commentary will also explain that funds transferred to the bank by way of anticipated reimbursement of a future payment obligation that the bank has accepted in the ordinary course of its banking business is also covered to the extent that the person that gave the bank instructions has a claim to those funds if the bank does not make the future payment.*]

(gg) A secured creditor has "control" with respect to a right to payment of funds credited to a bank account: (i) automatically upon the creation of a security right if the depositary bank is the secured creditor; (ii) if the depositary bank has concluded a control agreement with the grantor and the secured creditor, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the right to payment of funds credited to the bank account without further consent of the grantor; or (iii) if the secured creditor is the account holder.

[*Note to the Working Group: The Working Group may wish to note that the commentary will explain that: (i) there is no obligation on a depositary bank to enter into a control agreement; (ii) that a secured creditor's rights will be subject to the rights and obligations of the depositary bank under law and practice governing bank accounts; (iii) a control agreement requires the consent of the grantor (as well as of the depositary bank) and the grantor retains the right to deal with the funds in the bank account until the secured creditor instructs the depositary bank otherwise (although in some control agreements, the funds would be blocked from the time of the conclusion of the control agreement). The commentary will also explain that (iii) covers situations where: (i) an existing account is transferred to the secured creditor, (ii) the secured creditor agrees with the grantor that funds should be deposited to an account to be opened later and (iii) the secured creditor is the only account holder (i.e. not merely a joint account holder).*]

(hh) "Intellectual property right" includes, subject to law other than the secured transactions law, patents, trademarks, service marks, trade secrets, copyright and related rights and designs. It also includes rights under licences of such rights.

(ii) "Proceeds" means whatever is received in respect of encumbered assets. For example, proceeds include what is received as a result of sale or other disposition or collection, lease, licence, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects, damage or loss. [*See A/CN.9/WG.VI/WP.26/Add.4, as well as note in A/CN.9/WG.VI/WP.26/Add.7, note to rec. rec. 3 (g).*]

(jj) "Priority" means the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant.

(kk) "Competing claimant" means:

(i) Another secured creditor with a security right in the same encumbered asset (whether as an original encumbered asset or proceeds);

(ii) In the context of the non-unitary system for acquisition security rights, the seller or financial lessor of the same encumbered asset that has retained title to it;

(iii) Another creditor of the grantor asserting a right in the same encumbered asset (e.g. by operation of law, attachment or seizure or a similar process);

(iv) The insolvency representative in the insolvency of the grantor; or

(v) Any buyer or other transferee (including a lessee or licensee) of the encumbered asset.

(ll) "Possessory security right" means a security right in tangibles that are in the actual possession of the secured creditor or of another person (other than the debtor or other grantor) holding the asset for the secured creditor.

(mm) "Non-possessory security right" means a security right in: (i) tangibles that are not in the actual possession of the secured creditor or another person holding the tangibles for the benefit of the secured creditor, or (ii) intangibles.

[*Note to the Working Group: The Working Group may wish to consider whether the (ll) and (mm) are necessary after the decision not to make such a distinction between possessory and non-possessory security rights. The terms are used only in recs. 1 (f) and 3 (c).*]

(nn) "Possession", except as the term is used in recommendations [28 and 80] with respect to the issuer of a negotiable document, means the actual possession of tangibles by a person or an agent or employee of that person, or by another person holding on behalf of that person, or an independent person that acknowledges that it holds for that person. It does not include constructive, fictive or symbolic possession.

(oo) "Issuer" of a negotiable document means the person who is obligated to deliver the tangibles covered by the document under the law governing negotiable documents.

[*Note to the Working Group: The Working Group may wish to note that the commentary will explain that, in the case of a so-called multimodal bill of lading (if it qualifies as a negotiable document under the applicable law), the "issuer" may be a person who subcontracts various portions of the transport of the goods to other persons but still takes responsibility for their transport and for any damage that might occur during carriage.*]

(pp) "Dispossession of the grantor" means the actual delivery of possession of the assets to be encumbered to the secured creditor or a third person (other than the grantor or an agent or employee of the grantor) that holds the assets on behalf of the secured creditor or to an independent person who acknowledges that it holds for the secured creditor.

(qq) "Insolvency court" means a judicial or other authority competent to control or supervise an insolvency proceeding.

(rr) "Insolvency estate" means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings.

(ss) "Insolvency proceedings" means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor's business conducted according to the insolvency law.

(tt) "Insolvency representative" means a person or body responsible for administering the insolvency estate.

(uu) "Buyer in the ordinary course of business" means a person that buys inventory in the ordinary course from a person in the business of selling tangibles of that kind and without knowledge that the sale violates the security rights or other rights of another person in the tangibles.

D. Examples of financing practices covered in the Guide

22. Set forth below are short examples of the types of secured credit transactions that the Guide is designed to encourage, and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use, and an effective secured transactions regime must be sufficiently flexible to accommodate many existing methods of financing, as well as methods that may evolve in the future.

1. Inventory and equipment acquisition financing

23. Businesses often obtain financing for specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the tangibles (inventory and equipment) purchased. In other cases, the financing is provided by a lender. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller retains title or the lender is granted a security right in the tangibles purchased to secure the repayment of the credit or loan.

24. Here is an illustration of acquisition financing: ABC Manufacturing Company (ABC), a manufacturer of furniture, wishes to acquire certain inventory and equipment for use in manufacturing operations. ABC desires to purchase paint (constituting raw materials and, therefore, inventory) from Vendor A. ABC also wishes to purchase certain drill presses (constituting equipment) from Vendor B and certain conveyor equipment from Vendor C. Finally, ABC wishes to lease certain computer equipment from Lessor A.

25. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within thirty days of Vendor's A invoice to ABC, and ABC grants to Vendor A a security right in the paint to secure the purchase price. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the drill presses within ten days after they are delivered to ABC's plant. ABC obtains a loan from Lender A to finance the purchase of the drill presses from Vendor B, secured by a security right in the drill presses. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the bank account as additional security for the repayment of the loan.

26. Under the purchase agreement with Vendor C, ABC is required to pay the purchase price for the conveyor equipment when it is installed in ABC's plant and rendered operational. ABC obtains a loan from Lender B to finance the purchase and installation of the conveyor equipment from Vendor C, secured by a security right in the conveyor equipment.

27. Under the lease agreement with Lessor A, ABC leases the computer equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a "financial lease". Under some forms of financial leases, title to the leased property is transferred to the lessee automatically at the end of the lease term. A financial lease is to be distinguished from what is usually called an "operating lease". Under an operating lease, the leased property is expected to have a remaining useful life at the end of the lease term and the lessee does not have an option to purchase the leased property at the end of the lease term for a nominal price, nor is title to the leased property transferred to the lessee automatically at the end of the lease term.

28. In each of the above four cases, the acquisitions are made possible by means of acquisition financing provided by another person (seller, lender or financial lessor) who holds rights in the acquired property for the purpose of securing the acquisition financing granted. As the illustrations make clear, acquisition financing can occur with respect to both inventory and equipment.

2. Inventory and receivable revolving loan financing

29. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

30. One highly effective method of providing such working capital is a revolving loan facility. Under this type of credit facility, loans secured by the borrower's existing and future inventory and receivables are made from time to time at the request of the borrower to fund the borrower's working capital needs (see also A/CN.9/WG.VI/WP.11/Add.2, para. 12). The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Thus, borrowings and repayments are frequent (though not necessarily regular) and the amount of the credit is constantly fluctuating. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, processing inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower, and helps the borrower to avoid borrowing more than it actually needs.

31. Here is an illustration of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving loan facility to ABC to finance this process. Under the loan facility, ABC may obtain loans from time to time in an aggregate amount of up to 50 percent of the value of its inventory that Lender B deems to be acceptable for borrowing (based upon it's the type and quality of the inventory, as well as other

criteria) and of up to 80 percent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the account debtors). ABC is expected to repay these loans from time to time as it receives payments from its customers. The loan facility is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the bank account into which customer payments (i.e. the proceeds of inventory and receivables) are deposited.

3. Securitization

32. Another highly effective form of financing involving the use of receivables is securitization. Securitization is a sophisticated form of financing under which a business enterprise can obtain less-expensive financing based on the value of its receivables by transferring them to a wholly-owned "special purpose vehicle" ("SPV") that will issue commercial paper or other securities in the capital markets secured by the stream of income generated by such receivables. For example, this technique is commonly used in situations where a company's receivables consist of credit card receivables, rents or home mortgages, though the securitization of many other types of receivables is possible. Securitization transactions are complex financing transactions that are also dependent upon a jurisdiction's securities laws as well as its secured lending laws.

33. Securitization is intended to lower the cost of financing because the SPV is structured in a way to make the risk of its insolvency "remote" (e.g. theoretically not possible). That significantly reduces one risk that the lender has to take into account when deciding what interest rate to charge for the loan. In addition, as the source of credit is capital markets, greater amounts of credit may be generated and at lower costs than the normal bank loan costs.

34. Here is an illustration of a securitization transaction: An SPV is created by a subsidiary of an automobile manufacturer to purchase automobile leases from automobile dealers throughout a geographically defined market. The automobile leases are purchased from the dealers for a discount from the projected value of the payment streams expected to be generated by such leases. The SPV then issues debt securities, under applicable securities laws, to investors in the capital market secured by such income stream. As payments are made under the leases, the SPV will use such proceeds to make payments on the debt securities.

4. Term-loan financing

35. Businesses often need financing for large, non-ordinary-course expenditures, such as the acquisition of equipment or the acquisition of a business. In these situations, businesses generally seek financing whereby loans are repaid over a fixed period of time (with principal being repaid in monthly, quarterly or other periodic instalments pursuant to an agreed-upon schedule or in a single payment at the end of the loan term).

36. As is the case with may other types of financing, businesses that do not have strong, well-established credit ratings will have difficulty obtaining term loan financing, unless the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States,

immovable property is the only type of asset that typically is accepted by lenders to secure term-loan financing and, as a result, in such States term-loan financing is often not available for other important asset types, such as equipment or the enterprise value of an entire business. This is most likely the case in States that do not have a modern secured transactions regime. However, many businesses, particularly newly established businesses, do not own any immovable property and, therefore, may not have access to term-loan financing. In other States, term loans secured by movables , such as equipment and even intellectual property and the enterprise value of the business, are common.

37. Here is an illustration of this type of financing: ABC desires to expand its operations and purchase a business in State Y. ABC obtains a loan (predicated on the value of, and secured by, substantially all of the assets of the business being acquired) from Lender C to finance such acquisition. The loan is repayable in equal monthly instalments over a period of ten years and is secured by existing and future assets of ABC and the entity being acquired.

5. Transfer of title for security purposes

38. In States that honour a form of transfer of ownership even when it does not entail a transfer of possession and is done for financing purposes, a transaction denominated as a transfer of title by way of security (or sometimes as a “fiduciary” transfer of title) is recognized. These transactions are essentially non-possessory security rights, and they are primarily used in States where the secured transactions law has not yet appropriately recognized non-possessory security rights.

6. Sale and leaseback transactions

39. A “sale and leaseback transaction” provides a method by which a company can obtain credit based upon its existing tangibles (usually equipment) while still retaining possession and the right to use the tangibles in the operation of its business. In a sale and leaseback transaction, the company will sell its assets to another person for a specific sum (which it may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement. Often, the lease is a “financial lease” as opposed to an “operating lease” (see para. 27 for a definition of both terms).

II. Key objectives of an effective and efficient secured transactions regime

40. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime.

A. Promote secured credit

41. The primary overall objective of the Guide is to promote low-cost secured credit for persons in jurisdictions that adopt legislation based on the Guide's recommendations, thereby enabling such persons and the economy as a whole to obtain the economic benefits that flow from access to such credit (see para. 2).

B. Allow utilization of the full value inherent in assets to support credit in a broad array of credit transactions

42. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (i) permitting a broad range of assets to serve as encumbered assets (including present and future assets); (ii) permitting a broad range of obligations (including future and conditional, monetary and non-monetary, obligations) to be secured by security rights in encumbered assets; and (iii) extending the benefits of the regime to a broad array of debtors, creditors and credit transactions.

C. Enable parties to obtain security rights in a simple and efficient manner

43. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include: eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or actions by the parties.

D. Recognize party autonomy

44. Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the Guide stresses the need to keep mandatory rules to a minimum so that parties may tailor their credit transactions to their specific needs. At the same time, the Guide takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

E. Provide for equal treatment of diverse sources of credit

45. Because healthy competition among all potential creditors is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions

regime apply equally to various creditors, including banks and other financial institutions, as well as domestic and non-domestic creditors.

F. Validate non-possessory security rights

46. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with mechanisms for publicizing the existence of such security rights.

G. Encourage responsible behaviour on the part of all parties by enhancing predictability and transparency

47. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns.

H. Establish clear and predictable priority rules

48. A security right will have little or no value to a creditor unless the creditor is able to ascertain, at the time a transaction takes place, its priority in the property relative to other creditors (including an insolvency representative). Thus, the Guide proposes the establishment of a system for registering public notices with respect to security rights and, based on that system, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

I. Facilitate enforcement of creditor's rights in a predictable and efficient manner

49. A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner. Thus, the Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

J. Balance the interests of the affected persons

50. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

K. Harmonize secured transactions laws, including conflict-of-laws rules

51. Adoption of legislation based on the recommendations contained in the Guide will result in harmonization of secured transactions laws (through the adoption of similar substantive laws which will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade and the movement of goods and services across national borders. Furthermore, to the extent complete harmonization of national secured transactions laws might not be achieved, conflict rules would be particularly useful to facilitate cross-border transactions. In any event, conflict-of-laws rules would be useful in order, for example, to help secured creditors determine how to make their security rights effective against third parties.