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Registration of security rights in movable assets

Note by the Secretariat

Contents

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Background information

1. At its forty-second session (Vienna, 29 June-17 July 2009), the Commission noted with interest the future work topics discussed by Working Group VI at its fourteenth and fifteenth sessions (A/CN.9/667, para. 141, and A/CN.9/670, paras. 123-126, respectively). At that session, the Commission agreed that the Secretariat could hold an international colloquium early in 2010 to obtain the views and advice of experts with regard to possible future work in the area of security interests. [1] In accordance with that decision, [2] the Secretariat organized an international colloquium on secured transactions (Vienna, 1-3 March 2010). At the colloquium several topics were discussed, including registration of security rights in movable assets, security rights in non-intermediated securities, a model law on secured transactions, a contractual guide on secured transactions, intellectual property licensing and implementation of UNCITRAL texts on secured transactions. The colloquium was attended by experts from governments, international organizations and the private sector.[3]

2. At its forty-third session (New York, 21 June-9 July 2010), the Commission considered a note by the Secretariat on possible future work in the area of security interests (A/CN.9/702 and Add.1). The note discussed all the items discussed at the colloquium. The Commission agreed that all issues were interesting and should be retained on its future work agenda for consideration at a future session on the basis of notes to be prepared by the Secretariat within the limits of existing resources. However, in view of the limited resources available to it, the Commission agreed that priority should be given to registration of security rights in movable assets.[4]

3. In that connection, it was widely felt that a text on registration of security rights in movable assets would usefully supplement the Commission's work on secured transactions and provide urgently needed guidance to States with respect to the establishment and operation of security rights registries. It was stated that secured transactions law reform could not be effectively implemented without the establishment of an efficient publicly accessible security rights registry. It was also emphasized that the *UNCITRAL Legislative Guide on Secured Transactions* (the "*Guide*") did not address in sufficient detail, the various legal, administrative, infrastructural and operational questions that needed to be resolved to ensure the successful implementation of a registry.[5]

4. The Commission also agreed that, while the specific form and structure of the text could be left to the Working Group, the text could: (a) include principles, guidelines, commentary, recommendations and model regulations; and (b) draw on the *Guide*, texts prepared by other organizations and national law regimes that have introduced security rights registries similar to the registry recommended in the *Guide*. After discussion, the Commission decided that the Working Group should be

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[1] Ibid., *Sixty-fourth session, Supplement No. 17* (A/64/17), paras. 313-320.

[2] Ibid.

[3] For the colloquium papers, see www.uncitral.org/uncitral/en/commission/colloquia/3rdint.html.

[4] Ibid., *Sixty-fifth session, Supplement No. 17* (A/65/17), paras. 264 and 273.

[5] Ibid., para. 265.

entrusted with the preparation of a text on registration of security rights in movable assets.[6]

5. The present note is a preliminary discussion draft intended to assist the Working Group in its deliberations. Once the Working Group has reached a working assumption as to the form and structure of the text to be prepared, it may wish to consider requesting the Secretariat to prepare that text.

I. Introduction

6. The *Guide* reflects global recognition of the economic importance of a modern legal framework to support financing against the security of movable assets. The establishment of a registry in which information about the potential existence of security rights in movable assets may be made public is an essential feature of the law recommended in the *Guide* and of reform initiatives in this area generally.

7. Chapter IV of the *Guide* already contains commentary and recommendations on many aspects of a security rights registry system. However, in order to understand the requirements and legal effects of registration, as well as the scope of the registry, the reader would need to have a rather thorough understanding of the *Guide* as a whole. Thus, a text on registration could usefully begin with an integrated concise summary of the legal function of a security rights registry for States that have adopted or wish to adopt a modern legislative framework for secured lending along the lines of that recommended in the *Guide*. This text would be particularly useful not only to those involved in the registry implementation process, who are not legal experts but who will need to have a basic understanding of the legal context of the registry in order to carry out their work knowledgeably, but also to the registry clientele and others (see para. 16 below).

8. In addition, a security rights registry differs fundamentally from the kinds of registries for recording title and encumbrances on title in immovable property and high-value equipment, such as ships, with which many States are most familiar.[7] Thus, a text on registration could usefully elaborate on the key characteristics of a security rights registry that mark it apart from other types of registries and contribute to its efficient operation, including such concepts as notice registration, and grantor-based indexing.

9. Moreover, the statutory framework governing secured transactions typically leaves the detailed legal rules applicable to the registration and search process to be dealt with in subordinate regulations, ministerial guidelines and the like. Chapter IV of the *Guide* provides recommendations on the general policy issues associated with these legal issues. However, a text on registration could provide concrete examples of the types of legal rules, regulations, guidelines and forms for submitting

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[6] Ibid., paras. 266-267.

[7] It should be noted, however, that there are registries in some States in which both security rights in movable assets and encumbrances on immovable property may be registered in one registry. The requirements for the description of the encumbered asset and the legal consequences of registration may be different in each case, but the basic concept of notice as opposed to document registration is the same.

registrations and search requests that must be drafted as part of the implementation process.

10. Furthermore, chapter IV of the *Guide* does not address, or does not address in every detail, the myriad of technological, administrative, and operational issues involved in developing and running an effective and efficient security rights registry. Thus, a text on registration could usefully complement the *Guide*, first, by addressing these practical issues in a more specific and expanded fashion and, second, by explaining the need for a team-based implementation strategy, incorporating different types of specialists.

11. It should also be noted that the experience of States that have instituted the kind of comprehensive registry system contemplated by the *Guide* demonstrate how advances in computer technology can vastly improve the efficiency of operation of security rights registries. Thus, particularly in relation to the technical aspects of registry design and operation, a text on registration could usefully draw on these national precedents to provide valuable guidance to other States.

12. In addition to the *Guide* itself and particularly chapter IV, the text on registration could also usefully consolidate and refine the analysis and approaches of other international sources, including the following:

(a) The European Bank for Reconstruction and Development (EBRD) Publicity of Security Rights: Guiding Principles for the Development of a Charges Registry (2004);

(b) Publicity of Security Rights: Setting Standards (2005);

(c) The Asian Development Bank (ADB) Guide to Movables Registries (2002);

(d) The Draft Common Frame of Reference (DCFR) of the Principles, Definitions and Model Rules of a European Private Law: Section 3 of Chapter 3 (Effectiveness as Against Third Parties) (Registration) of Book IX (Proprietary Security in Movable Assets) (2010);

(e) The Organization of American States (OAS) Model Registry Regulations under the Model Inter-American Law on Secured Transactions (October 2009);

(f) The International Finance Corporation (World Bank) Secured Transactions Systems and Collateral Registries (January 2010);

(g) The Organisation pour l' Harmonisation du Droit des Affaires en Afrique (OHADA) Treaty: recent developments in relation to the establishment of a regional security rights registry; and

(h) The Convention on International Interests in Mobile Equipment (Cape Town, 2001) and its Protocols, establishing international registries (which although are asset-based and cover also transactions other than secured transactions, are notice based and registration results in third-party effectiveness and priority).

13. The national and international sources referred to above do not always accord with the recommendations in chapter IV of the *Guide* on registration-related issues. Consequently, the text on registration could explain the policy rationale for UNCITRAL's preferred approach relative to other possible approaches.

14. In addition, a text on registration could include overarching principles that should guide the registry implementation process. A discussion of principles could, for example, focus on the following:

(a) Legal efficiency: the legal and operational guidelines for registration and searching should be simple, clear and certain;

(b) Operational efficiency: the registration and search process should be designed to be as fast and inexpensive as is compatible with ensuring the security of the information in the registry; and

(c) Equality of treatment of constituents and users: grantors, secured creditors, and potential competing claimants all have an interest in the extent and scope of information that is published in a security rights registry and in the efficient availability of that information; thus, the legal and operational framework of the registry should be designed to fairly balance the interests of all its potential constituents and users.

15. A text on registration could also include commentary, sample rules dealing with the legal and practical aspects of the registration and searching process (for the law or regulations) and sample forms.

16. The potential readership of a text on registration comprises all those who are interested or actively involved in the design and implementation of a security rights registry as well as those who may be affected by its establishment, including:

(a) Registry system designers, including technical staff charged with specifying or fulfilling the hardware and software requirements for the registry;

(b) Registry administrators and staff;

(c) Registry clientele (in addition to credit providers, credit reporting agencies and insolvency representatives, all members of the public whose legal rights may be implicated by market transactions involving movable assets potentially subject to a security right);

(d) The general legal community (including judges, arbitrators and practicing lawyers); and

(e) All involved in secured transactions law reform and law reform assistance (such as the World Bank, the EBRD, the ADB and the Inter-American Development Bank).

17. Not all of these potential readers will be versed in the intricacies of secured credit law or even have legal training. Accordingly, the text on registration should ideally be drafted in an accessible “plain language” style and employ “reader-friendly” graphic aids (for example, summary checklists, implementation timelines, textboxes giving concrete factual examples).

18. Like the *Guide*, the text on registration could also be drafted in a fashion that enables it to be adopted by States with diverse legal traditions. Consequently, to the extent that the text provides model rules and forms for registration and searching, these should use neutral generic terminology that can be adapted readily to each State’s domestic legal tradition and drafting style as well as to local legislative conventions regarding which types of rules must be incorporated in principal legislation and which may be left to subordinate regulations or ministerial or

administrative guidelines. In any case, a text on registration must clearly indicate the scope of the legal and technical terms it uses, pointing out where these have a different meaning from similar terms in the *Guide*.

[*Note to the Working Group: The Working Group may wish to note that, as a matter of drafting, while reference is made in the note to a "notice", a term used in the* Guide*, where possible, reference is also made to "information in the registry" or "information registered". The reason for this approach is that a registrant does not register a security right or a notice of a security right. The registrant transmits "information" to the registry in order to effect a "registration". What is entered into the registry database is not a notice but the "information" with the result that a "registration" is created. In the appropriate circumstances, a "registration" (not a notice of registration) is amended or discharged. A searcher searches the registry database in order to determine whether a registration (not a notice) relating to a grantor exists. Thus, the Working Group may wish to consider whether: (a) in line with the terminology used in the* Guide*, the term "notice" should be used in the text on registration with appropriate explanation of its meaning along the lines mentioned above; or (b) instead of the term "notice", a term along the lines of "information in the registry", "registered information" or "registration information" should be used, again with appropriate explanation that the new term refers to the substance of the term "notice".*]

II. Purpose of a security rights registry

A. Introduction

19. A security rights registry does not exist in a vacuum. It is an integral component of the overall legal and economic context of secured financing regime in a particular State. Yet those who are involved in the design and implementation of a security rights registry, as well as the potential clientele of the registry, may not be familiar with the intricacies of secured financing. Therefore, a text on registration could provide an overview of secured credit and the legal function of registration within a modern legislative framework for secured financing. This is the goal of this chapter.

B. Function of a security right

20. Although the legal terminology may vary, the basic idea of a security right is much the same everywhere. A security right is a type of property right given to a creditor to secure payment of a loan or other obligation (see the term "security right" in the introduction to the *Guide*, sect. B). A security right mitigates the risk of loss resulting from a default in payment by entitling the creditor to claim the value of the assets encumbered by the security right as a back-up source of repayment. For example, if a business that borrows funds on the security of its equipment fails to repay the loan, its secured creditor will be entitled to have the equipment seized and sold in order to pay off the outstanding balance. The central feature of a security right is that it generally enables a creditor to appropriate the value of encumbered assets by preference over other competing claimants. As the risk of loss from a debtor default is mitigated, the terms of the credit agreement may be more

favourable for the debtor (for example, the interest rate may be lower, the amount of the credit may be higher and the repayment period may be longer).

21. Security is generally created by a contract (security agreement) in which the grantor of the security right consents to have specified assets stand as security for a specified obligation. Sometimes, the specified obligation is a loan, sometimes it is a credit facility such as a line of credit typically offered by financial institutions. In other instances, it may be an extension of credit in conjunction with the acquisition of goods by the grantor. For example, a seller may reserve ownership in assets sold on credit in order to secure payment of the purchase price (for the treatment of retention of title in a modern secured transactions regime, see the *Guide*, chap. IX; see also paras. 23 and 24 below).

22. Sometimes security rights are created by the law itself rather than by the voluntary agreement of the parties. For example, in many States, a security right arises by operation of law in assets of persons who are indebted to a government agency resulting from unpaid taxes or levies. In addition, in other States, a person that obtains a judgment is entitled by operation of law to a security right in the judgment debtor's assets to secure payment of the judgment debt. Moreover, in some States, persons that repair tangible assets (e.g. vehicles) are given a statutory security right in those assets to secure payment of the unpaid repair charges upon surrender of possession of the assets to the customer.

C. Reasons for secured credit

23. Commercial enterprises typically require some form of financing to support their start-up and expansion costs and to enable them to acquire or produce the equipment, inventory and services from which they hope to generate profits. Consequently, credit performs an important role in financing productive business development. Consumers as well may require access to credit to enable them to acquire assets such as household appliances and motor vehicles. As already mentioned, a creditor that is forced to rely solely on a borrower's promise to repay is likely to extend only a small amount of credit for a short period of time, at a high interest rate and then only to a borrower that has an established credit record. Security tends to enhance access to credit at lower cost and for a longer duration because of the additional protection it offers financiers against the risk of default in payment. Indeed, many consumers and small and medium sized businesses are unable to access credit at all unless they are able to offer security in their assets (see introduction to the *Guide*, paras. 1-11).

D. Possessory and non-possessory security rights

24. Legal systems have long recognized security rights in the form of the classic possessory pledge (see the *Guide*, chap. I, paras. 51-59). In a pledge transaction (leaving aside fictional pledge transactions and pledge transactions in which actual possession does not change hands), the grantor typically delivers actual possession of the encumbered asset to the secured creditor. The requirement for delivery of possession means that the secured creditor can be confident that the debtor has not already encumbered the asset in favour of another creditor. Dispossession of the

grantor also alerts potential buyers and other transferees that the grantor no longer has unencumbered title to the asset.

25. However, possessory pledges are practical only if the asset is capable of physical delivery. This excludes many types of movable asset, including the grantor's future assets (that is, assets acquired by the grantor or produced after the creation of a security right; see the *Guide*, chap. I, para. 8), as well as its intangible assets, such as receivables and intellectual property rights. Even when delivery of possession is feasible, the secured creditor normally will not be in a position to store, maintain and insure bulky assets or assets that are constantly circulating, such as inventory. Finally, giving up possession may defeat the purpose of the financing. An enterprise needs to retain possession of its equipment, inventory and other business assets in order to generate the income to pay the secured obligation. Similarly, postponement of delivery of tangible assets purchased on secured credit terms would deprive consumers of the present benefit of use and enjoyment of the assets (for a discussion of the advantages and disadvantages of possessory pledges, see the *Guide*, chap. I, paras. 51-59).

26. In view of the limitations of possessory security, modern secured transactions laws generally permit security to be granted without the need for a delivery of possession of the encumbered asset to the secured creditor. A legal regime that recognizes non-possessory security rights also tends to increase access to credit by expanding the range of assets that a business can offer as security. An enterprise can encumber its intangible assets in addition to its tangible assets, and its future assets (most significantly, its receivables and its inventory) in addition to its present assets (for the assets that may be subject to a security right, see the *Guide*, recommendation 17; in particular for security rights in all assets of a grantor, see the *Guide*, chap. II, paras. 61-70). Non-possessory security also enhances consumer access to credit since it enables the consumer to take immediate possession of assets purchased with a loan or credit facility.

E. Legal risks of non-possessory security rights

27. It is inherent in the very idea of a security right as a property right that the secured creditor has the right in the event of the grantor's default to claim the value of the encumbered asset in preference to the claims of competing claimants, including subsequent buyers and secured creditors, as well as the grantor's unsecured creditors and insolvency representative (see the terms "competing claimant" and "priority" in the introduction to the *Guide*, sect. B). However, the recognition of non-possessory security rights poses information challenges for third parties. It is important for potential buyers or secured creditors to be certain that assets in a person's possession are not subject to a prior security right. It is equally important for unsecured creditors and the grantor's insolvency representative to be able to determine which of the grantor's assets are already encumbered and therefore potentially not available to satisfy their claims. In the face of these information challenges, legal systems may be reluctant to permit the holder of a non-possessory security right to pursue its security right against competing claimants that acquire a right in the encumbered asset without actual knowledge of the existence of the security right. On the other hand, the value of a security right to a creditor is diminished to the extent that rules protecting third

parties without knowledge of a pre-existing security right enable them to take their rights in the encumbered assets free of the pre-existing security right in those assets.

F. How a registry may resolve legal risk

28. The establishment of a security rights registry enables States to resolve the "secrecy" problem posed by non-possessory security rights in a manner that protects the rights of both secured creditors and third parties. If registration is made a condition of the effectiveness of a security right against competing claimants, third parties can protect themselves by searching the registry in advance of dealing with the grantor's assets. Secured creditors in turn are assured that if they register in time, their security rights will be effective against subsequent competing claimants. Registration also offers a transparent and fair method of ranking of security rights where the grantor has created security rights in the same asset in favour of more than one secured creditor.

29. To achieve these benefits, the establishment of a registry must be complemented by a supportive legal framework. In particular, the secured transactions law under which the registry is established will need to incorporate the three basic rules of a registry-based secured transactions law. First, registration is a precondition to the effectiveness of a non-possessory security right against third parties (see the *Guide*, recommendations 29 and 32). Second, the holder of a registered non-possessory security right is entitled, in the event of the grantor's default, to the value of the encumbered asset up to the maximum amount of the obligation as indicated in the registered notice as against subsequent competing claimants (see the *Guide*, recommendation 98). Third, priority among registered non-possessory security rights in the same asset is determined by the order of registration (see the *Guide*, recommendation 76, subpara. (a)). Although these represent the baseline rules, a modern secured transactions law invariably will recognize some qualifications in the interests of facilitating other policy objectives. The next section offers some typical examples.

G. Transactional scope of the registry

1. General approach: substance over form

30. Subject to the qualifications just noted, modern registry-based secured transactions regimes are comprehensive in scope, covering all transactions that in substance operate as security regardless of the form of the transaction, the type of encumbered asset or the secured obligation, or the status of the parties (see the *Guide*, recommendation 2). So, for example, if a debtor transfers title to an asset to a creditor under a "sale", but retains possession on the understanding that title may be redeemed on payment of the outstanding obligation, the sale will be regulated by the same registration and priority rules that apply to nominal security rights. This approach is necessary to avoid undermining the risk reduction and priority ordering benefits of establishing a registry.

31. It should be noted that this approach does not mean that title transactions covered by the registration regime are re-characterized as secured transactions. For example, as noted below, outright transfers of receivables are normally subject to

registration and some of the secured transactions rules apply to those transactions as well (see the *Guide*, recommendation 3); however, this does not make an outright transfer of a receivable a secured transaction as this result would be undesirable and harmful for important practices relating to outright sales of receivables such as factoring or securitization (see the *Guide*, chap. I, paras. 25-31).

2. Outright assignments of receivables

32. An outright assignment of a receivable creates the same problem of information inadequacy for third parties as a non-possessory security right. A potential secured creditor or assignee has no efficient means of verifying whether the receivables owed to a business already have been assigned. While inquiries could be made of the debtors of the receivables, this is not practically feasible where the transaction covers present and future receivables generally. To address this concern, secured transactions law often extends the registration requirements applicable to non-possessory security rights to outright sales of receivables, with priority among successive assignees or secured creditors of the same receivables determined by the order of registration.

3. Title retention security devices

33. Some States that adopt a "substance over form" approach to the characterization of a device as a security device for the limited purposes of secured transactions law limit this approach to transactions that involve the creation of a security right in assets already owned by the grantor. Transactions in which a creditor retains title to an asset for the purpose of securing payment of its acquisition price in instalments by the debtor (for example, title reservation sales and financial leases) are treated as conceptually distinct from security devices. However, even in these States, it is generally recognized that these transactions raise the same publicity concerns as non-possessory security rights. In the absence of a registration requirement, a third party would have no means of objectively verifying whether assets in a person's possession may in fact be subject to the ownership rights of a seller or lessor. Consequently, a modern secured transaction registry regime often also brings reservation of title within its scope, requiring registration as a precondition to the seller or lessor setting up its ownership rights against third parties.

34. In recognition of the importance of supplier credit, however, a modern secured transactions law will normally exclude the seller or lessor from the application of the first-to-register priority rule (in other words, give the supplier a special priority position). Otherwise, a prior registered secured creditor that had taken security over the future assets of a grantor would be able to claim the assets in priority to the seller or lessor. This would be inappropriate for the same reasons that justify an exception to the first-to-register priority rule for the holders of acquisition security rights. First, the debtor acquired the asset as a result of the seller or lessor's extension of credit, not the credit extended by the prior registered secured creditor. Second, giving priority to a prior registered security right would discourage access to sales and lease financing credit. Consequently, a modern secured transactions regime protects the seller or lessor provided registration has been made in a timely fashion (see, for example, the *Guide*, recommendation 180).

4. True leases and consignments for sale

35. True long-term leases and consignment sales of movable assets do not operate to secure the acquisition price of assets. However, they create analogous publicity problems for third parties since they necessarily involve a separation of a property right (the ownership of the lessor or consignor) from actual possession (which is with the lessee or consignee). To address this concern, some States expand the scope of the registration and priority regime, which is applicable to acquisition security rights, transfer and title retention security devices, to these types of transaction.

5. Non-consensual security rights

36. A registry of security rights in movable assets is designed primarily to accommodate the registration of consensual non-possessory security rights in such assets. However, as noted earlier, a security right can also be created by operation of law. In principle, the same registration and priority rules that apply to consensual security rights may apply to security rights created by operation of law. In some States, however, certain types of non-consensual security right may be given a special priority over even prior-registered consensual security rights. This is the case, for example, with security rights arising by operation of law to secure revenue obligations owing to the State. In this situation, the State does not need to register since the usual first-to-register priority rule does not apply.

H. Exceptions to registration-based third-party effectiveness and priority rules

1. Possessory security rights

37. Although most secured transactions involve non-possessory security rights, the possessory pledge is still used commonly for certain types of asset, such as luxury personal assets, negotiable instruments, negotiable documents and certificated securities. States that have implemented a registry system almost invariably permit taking possession as an alternative to registration as a means of achieving third-party effectiveness of a security right (see the *Guide*, recommendation 37). It is felt that dispossession of the grantor constitutes sufficient practical notice to third parties that the grantor's title is unlikely to be unencumbered. In these cases, priority is generally determined by the respective order of registration or possession. However, with respect to certain types of asset, such as negotiable instruments or negotiable documents, a security right made effective against third parties by possession has priority even over a previously registered security right (see the *Guide*, recommendations 101 and 109).

2. Acquisition financing

38. A first-to-register rule of priority means that a security right in the future assets of an enterprise (that is, assets that are acquired or come into existence after the security right is created), a notice of which is registered, will have priority over security rights in the same assets, a notice of which is registered later. This is reasonable, as a general rule, since a subsequent secured creditor could and should protect itself by searching the registry before extending credit. However, most modern secured transactions laws recognize that there should be an exception where

the subsequent secured creditor is financing the grantor's acquisition of new assets (for example, consumer goods, equipment or inventory). As these new assets would not have formed part of the grantor's asset base but for the new financing, it is considered fair that the acquisition financier (the later-registered secured creditor) should have priority with respect to the value of those assets over of the earlier-registered creditor. Giving priority to acquisition security rights also benefits the grantor by giving it access to diversified sources of secured credit to finance new acquisitions (see the *Guide*, chap. IX).

3. Ordinary-course-of-business transactions

39. In many States, a buyer that acquires an encumbered asset without actual knowledge that it is subject to a security right ("a good faith buyer") takes the asset free of a registered security right. Under this approach, a potential buyer is not only under no obligation to search the registry to determine whether the asset in which it is interested is subject to a security right, but has also a positive incentive not to search. This extensive level of protection for buyers based on subjective knowledge standards is incompatible with a modern registry system aimed at facilitating publicity of security rights and establishing clear and objective rules for resolving contests between competing claimants. Consequently, modern secured transactions regimes typically enable a secured creditor in such cases to follow the asset into the hands of buyer from the grantor (for the effect of actual knowledge on third-party effectiveness and priority, see also paras. 48 and 49 below).

40. However, the secured creditor's general right to enforce its security right against an encumbered asset in the hands of a buyer is subject to an important qualification. Modern secured transactions laws almost invariably provide that a buyer that purchases an encumbered asset in the ordinary course of the grantor's business acquires the asset free of any security right in it, whether registered or not (see the *Guide*, recommendation 81). It is not realistic to expect buyers buying assets from a commercial enterprise which routinely sells the type of asset in which the buyer is interested, for example, computer equipment, to check the registry before entering into the transaction. It should be noted that the ordinary-course-of-business exception typically protects a buyer even when the buyer had actual knowledge of the existence of the registered security right but not when the buyer additionally knew that the sale violated the rights of the secured creditor under the security agreement. This approach is consistent with the reasonable commercial expectations of both the grantor and the secured creditor. A secured creditor that takes a security right in a grantor's inventory will normally have done so on the understanding that the inventory may be sold free of the security right in the ordinary course of the grantor's business. After all, the grantor's ability to sell its inventory is necessary to generate the funds necessary to pay back the secured loan.

41. Secured transactions laws typically extend similar protection to transferees and competing secured creditors to whom money is paid or in whose favour negotiable documents (such as a bill of lading) or negotiable instruments (such as a cheque) are negotiated (see the *Guide*, recommendations 101 and 109). Here, the policy of preserving the negotiable quality of the encumbered asset, the document covering, or the instrument relating to, the encumbered asset, in the market place is considered to outweigh the risk to the priority position of the registered secured creditor.

4. Bank accounts and securities

42. In the interest of facilitating transactions by large financial institutions in the securities lending, repurchase and derivatives markets, legal systems often create exceptions to registration-based priority ordering for security rights in bank accounts and, at least, certain types of securities (it should be noted though that securities and payment rights arising under or from financial contracts and foreign exchange contracts are excluded from the scope of the *Guide*; see recommendation 4, subparas. (c)-(e)). Under the typical approach, secured creditors have the option of taking "control" of the bank account or certain types of securities in lieu of registration; and secured creditors with "control" have priority even over earlier-registered security rights (with respect to bank accounts, see the term "control" in the introduction to the *Guide*, sect. B, and recommendation 103).

5. Assets subject to specialized registries

43. Other exceptions may be based on the decision to retain existing well-functioning alternatives to registration in the general security rights registry. Some States, for example, have adopted a system for recording security rights on the title certificates for motor vehicles. If this system works well, the State may choose to exclude security rights in the assets covered by this system from the scope of the registration regime or simply give priority to security rights registered in a specialized registry (for the latter approach, see the *Guide*, recommendations 77 and 78).

44. In addition, a State may already have in place specialized registries for recording rights, including security rights, in specific types of movable asset, notably, ships, aircraft and intellectual property. To the extent that these registries may serve broader goals than simply publicizing security rights in the relevant assets, a State may decide to exclude from the scope of the security rights registry security rights in assets to which specialized registration applies or simply give priority to security rights registered in a specialized registry (for the latter approach, see the *Guide*, recommendations 77 and 78).

45. Finally, States parties to international treaties, such as the Convention on International Interests in Mobile Equipment and its Protocols will require registration in the international registry for security and other rights in the types of asset to which these treaties apply (for example, aircraft frames and engines, and railway rolling stock).

6. Other exceptions

46. The extent to which other exceptions are recognized depends on the particular social and economic context of each State. Some States, for example, may wish to protect buyers of relatively low-value consumer assets, whether or not purchased in the ordinary course of the seller's business. Here, the theory is that it is unrealistic to expect them to undertake a registry search in advance of the transaction. Statutory security rights that should ideally be registered are also often excluded.

I. Territorial scope of the registry

47. Secured creditors require clear guidance on where a security right must be registered in situations where the transaction involves parties and assets located in different States. Typically, this guidance is found in a State's conflict-of-laws rules for determining the law applicable to the third-party effectiveness and priority of a security right. Under the approach adopted in most modern conflict-of-laws regimes, the applicable law turns on the nature of the assets. For security rights in tangible assets, the law of the location of the encumbered asset applies (see the *Guide*, recommendation 203). Where the encumbered assets are located in multiple States, it follows that multiple registrations will be needed. For security rights in intangible assets, as well as mobile goods of a kind that are commonly used in multiple States, the law of the State in which the grantor is located applies (see the *Guide*, recommendations 204 and 208).

J. Effect of actual knowledge on third-party effectiveness and priority

48. The question arises whether a third party that acquires an encumbered asset with actual knowledge of an unregistered security right should take the asset free of that security right. In general, modern regimes stipulate that actual notice or knowledge of the existence of a security right is not a substitute for registration and that acquiring an encumbered asset with knowledge of the existence of an unregistered security right does not constitute bad faith. This approach enables third parties to place full confidence in the registry system to determine whether or not they are bound by any security rights the grantor may have given in its assets. It is not unfair to secured creditors since they could have protected themselves by timely registration.

49. Knowledge that a transfer, lease or licence violates the rights of an existing secured creditor is a different matter. Such knowledge on the part of a buyer, lessee or licensee may result in that party acquiring its rights in an encumbered asset subject to a pre-registered security right, even if the relevant transaction is in the ordinary course of business of the seller, lessor or licensor (see the *Guide*, recommendations 81 and 106, and the *Supplement*, recommendation 245).

K. Registration and the doctrine of constructive notice

50. Traditional legal regimes for secured lending sometimes treat registration as a constructive notice of a security right. Under the constructive notice doctrine, everyone that deals with an asset subject to a registered right is deemed to have knowledge of the existence of that right even if they have not in fact consulted the registry. The doctrine of constructive notice is irrelevant in a modern secured transactions legal framework in which the priority consequences of registration and failure to register are set out directly and comprehensively in the applicable legislation. For the most part, these priority rules do not depend on the knowledge of the existence of a security right, deemed or otherwise, of third parties that acquire rights in assets subject to a registered right. In the limited number of cases where knowledge is relevant, it is actual not constructive or deemed knowledge that is

important and it refers to knowledge of different facts, not the existence of the security right (see para. 49 above).

L. Registration and insolvency

51. Modern secured transactions laws generally make registration a pre-condition to the effectiveness of a security right against the grantor's unsecured judgment creditors and the grantor's insolvency representative (see the *Guide*, recommendations 238 and 239). Failure to register, or to register in time, means that the secured creditor is effectively demoted to the status of an unsecured creditor.

52. This rule:

(a) Encourages prompt registration by secured creditors;

(b) Enables the grantor's insolvency representative to efficiently determine which of the grantor's assets are encumbered;

(c) Enables judgment creditors to determine at any given time the extent to which the grantor's assets are encumbered, thereby enabling them to determine whether it is worthwhile to commence judgment enforcement proceedings; and

(d) Enables potential creditors to determine the possible extent of secured indebtedness of their potential debtors at any given time, knowledge that may contribute to their overall assessment of creditworthiness of a potential debtor.

53. Timely registration does not, however, protect a secured creditor from challenges on the basis of general insolvency law policies, such as rules avoiding preferential or fraudulent transfers and rules giving priority to certain protected classes of creditors (see the *Guide*, chap. XII, and recommendation 239; see also recommendation 88 of the UNCITRAL Legislative Guide on Insolvency Law).

M. Registration and creation of a security right

54. In a modern secured transactions regime, registration is not an element of the creation of a security right (see the *Guide*, recommendation 33). Rather the security right takes effect and becomes enforceable between the grantor and the secured creditor as soon as a security agreement that meets minimal formalities such as writing and evidence of the grantor's consent to encumber its assets is concluded (see the *Guide*, recommendations 13-15). Registration is purely a precondition to the third-party effectiveness of the security right. In addition, what is registered is not the security agreement itself but rather a separate notice (that is, information relating to a potential security right), typically entered into the registry in electronic form, that sets out only basic information about the security right (see the *Guide*, recommendation 32). The registration does not constitute evidence that the security right to which it refers actually exists. It is the off-record security agreement that evidences the security right. Registration merely alerts third-party searchers of the possible existence of a security right in the described assets.

N. Registration and enforcement

55. Some legal regimes require secured creditors to register a notice of the initiation of enforcement action. This is usually the case in legal systems in which registry staff are required to notify prior registered secured creditors that hold a security right in the same asset of the pending enforcement action. In other legal systems, the burden is on the enforcing secured creditor to search the registry and to give advance notice to the holders of competing registered security rights of the particular enforcement remedy that it seeks to exercise (see, for example, the *Guide*, recommendation 151).

O. Penalties for failure to register

56. Modern secured transactions laws do not impose monetary penalties or other administrative sanctions on secured creditors that fail to register the required information in relation to a security right. The inability to enforce the security right against third parties under the secured transactions law is a sufficient legal sanction in itself since failure to register effectively reduces the secured creditor to the status of an unsecured creditor.

P. Relationship between the security rights registry and specialized movable property registries

57. Modern secured transactions and registry regimes deal with the relationship between a State's security rights registry and specialized movable property registries (for example, for ships, aircraft or intellectual property). Where specialized registries exist and permit the registration of security rights in movable assets with third-party effects (as is the case with the international registries under the Convention on International Interests in Mobile Equipment and its Protocols), modern secured transactions and registry regimes deal with matters related to the coordination of registrations in the two types of registry.

58. For example, information registered in one registry may be forwarded to the other registry. Alternatively, information registered in one registry may be simultaneously entered into the other registry through a common gateway. Either one of these approaches would require coordination of registration systems. For example, the registry regimes should provide for both grantor and asset indexing and searching and accept notice rather than document registration. However, as already mentioned, the description requirements and the legal consequences of registration may be different (for the coordination between registries, see the *Guide*, chap. III, paras. 75-82, chap. IV, para. 117; see also the *Supplement*, paras. 135-140).

Q. Relationship between the security rights registry and immovable property registries

59. Immovable property registries invariably exist in most, if not in all, States. With the introduction of security rights registries in modern secured transactions regimes, the issue or the relationship between the two types of registry needs to be

addressed. In most States, the two types of registry are separate. In some States, however, information relating to security rights in movable assets and to encumbrances on immovable property may be registered in one registry. As already mentioned, the requirements for the description of the encumbered asset and the legal consequences of registration may be different in each case, but the basic concept of notice registration as opposed to document registration is the same.

60. The issues discussed above (section P) are relevant in this context as well. In addition, issues will arise with respect to where information relating to security rights in attachments to immovable property should be registered. Modern secured transactions and registry regimes provide that such registrations made be made in the general security rights registry or in the immovable property registry (see the *Guide*, recommendation 43). The choice between the two types of registration has priority consequences. Most States provide that an encumbrance registered in the immovable property registry has priority over a security right registered in the security rights registry (see the *Guide*, recommendation 87).

III. Key characteristics of an effective security rights registry

A. Introduction

61. Most States have established registries for recording title and encumbrances on titles for transactions involving immovable property as well as certain types of high-value movable assets, such as ships and aircraft. It is essential for the implementation of an effective security rights registry that its very different characteristics be well understood by those responsible for its design and by its potential clientele. Therefore, a text on registration should explain the key characteristics of an effective modern security rights registry. This is the goal of this chapter (additional key characteristics that are typically addressed in legal rules or relate to the registry design are addressed in A/CN.9/WG.VI/WP.44/Add.1, chapters IV and V respectively).

B. Determining title to encumbered assets

62. A title registry, such as the typical land or ship registry, operates to disclose both the current owner of a particular asset and any encumbrances on the owner's title. A security rights registry generally does not record the existence or transfer of title to the encumbered asset or guarantee that the person named as grantor is the true owner. It is purely and simply a record of security rights on whatever property right the grantor has or may acquire in the encumbered assets. Whether the grantor owns the encumbered assets described in a registration instead depends on the effectiveness of the off-record contract transactions under which the grantor claims title. It would not be administratively practical or cost effective to attempt to establish a reliable ownership record for the great bulk of tangible and intangible movable assets that are the subject of security rights.

63. As explained earlier, in the case of title retention devices, as well as true leases and consignments, the registration refers not to a security right but to the ownership right of the seller, lessor or consignor. Similarly, in the case of an outright

assignment of receivables, registration refers to the ownership right acquired by the assignee. However, registration even in these cases does not establish or evidence ownership.

C. Grantor versus asset indexing

1. Generally

64. The very different nature of movable assets as compared to immovable property and secured lending relating to these respective assets leads to a second point of distinction between title registries for immovable property and security rights registries for movable assets. This point is the manner in which registrations are indexed in the registry record. Immovable property has a sufficiently unique geographical identifier to enable registrations to be indexed and searched by reference to the asset. Most types of movable asset lack a sufficiently specific or unique objective identifier to support asset-based indexing. Moreover, a modern secured transactions law must accommodate the creation of an effective security right in pools of present and future assets such as the grantor's equipment, inventory and receivables. Asset indexing would require an item by item specific description making the registration process unbearably cumbersome and prone to errors in descriptions.

65. For both these reasons, registrations in a security rights registry are generally indexed by reference to the identifier of the grantor (the grantor's name or other identifier such as a State-issued identification number) as opposed to the asset (see the *Guide*, chap. IV, paras. 31-33 and 70). Grantor indexing greatly liberates the process of registration. Secured creditors can register a security right in a grantor's present and future movable assets, or in generic categories, through a single one-time registration.

2. Supplementary asset-based indexing

66. Grantor indexing has one drawback. If the grantor transfers the encumbered asset and the initial registration of the security right remains effective against transferees, third parties that deal with the asset in the hands of a transferee cannot protect themselves by conducting a search of the registry using the name of the transferee. Suppose, for example, the grantor sells an asset subject to a registered security right outright to a third party that, in turn, proposes to sell or grant security in it to a fourth party. Assuming the fourth party is unaware that the third party acquired the asset from the original grantor, he or she will search the registry using only the third party's name. That search will not disclose the registered notice.

67. In response to this problem, some security rights registry systems provide for registration and asset-based indexing in respect of "serial number goods" for which reliable numerical identifiers are available. Asset-based indexing is usually limited to movable assets for which there is significant re-sale market and which have a sufficiently high value to justify the additional legal complexity and reduced flexibility (for example, motor vehicles, trailers, mobile homes, aircraft frames and engines, railway rolling stock, boats and boat motors, although security rights in some of these types of asset are registered in specialized registries; see the *Guide*, chap. IV, paras. 34-36).

68. In fact, in some modern registry systems, both the grantor's identifier and serial number of assets (including consumer household appliances) may be entered and both grantor and serial number indexing is possible. Both grantor's identifier and serial number may be search criteria (there may even be a third search criterion, registration number). This approach enables a search to be undertaken on the specific serial number of an asset or on the grantor's identifier, and either of these search criteria would detect the registration. In some cases, however, if the encumbered assets are consumer goods and are described and indexed by serial number, the grantor's identifier may not be revealed (for privacy reasons).

D. Notice versus document registration

69. Registry systems for recording title and encumbrances on title to specific parcels of land or specific movable assets, such as ships, typically require registrants to file or tender for scrutiny the underlying documentation. This is because registration generally is considered to constitute evidence or at least presumptive evidence of title and any property rights affecting title.

70. Some traditional security rights registries still require submission of the underlying security documentation. However, modern secured transactions regimes invariably adopt notice registration. A notice-registration system does not require the actual security documentation to be registered or even tendered for scrutiny by registry staff. All that need be registered is a separate notice of the security right in standard form, setting out only the basic information necessary to alert a searcher that a security right may exist in the asset described in the notice. It follows that registration does not mean that the security right to which it refers necessarily exists; only that one may exist in the future (see, the *Guide*, recommendation 57).

71. By dramatically reducing the quantity of information that must be transmitted to the registry, notice registration:

(a) Reduces transaction costs for both registrants and third-party searchers;

(b) Reduces the administrative and archival burden on registry system operators;

(c) Reduces the risk of registration error (since the less information that must be submitted, the lower the risk of error); and

(d) Enhances privacy and confidentiality for secured creditors and grantors.[8]

72. As already mentioned, modern secured transactions and registry regimes provide that notice registration does not create a security right; it simply makes a security right effective against third parties if it exists at the time of registration or, in the case of advance registration, comes into existence later (see the *Guide*, recommendations 32, 33 and 67). In addition, such regimes foresee that, while a notice is not effective unless authorized by the grantor in writing, authorization given in the security agreement is sufficient and may be given even after

[8] For a discussion of related issues such as advance registration, the notion that one registration can cover multiple agreements, the benefits of electronic transmission and the required content of the notice, see A/CN.9/WG.VI/WP.44/Add.1, chap. IV.

registration, independently of the identity of the registrant (see the *Guide*, recommendations 55, subpara. (d), and 71). Moreover, to protect grantors from unauthorized registrations that may prevent them from utilizing their assets to obtain credit, such regimes recognize the right of a grantor to seek cancellation or amendment of a registration through a summary administrative or judicial procedure (see the *Guide*, recommendations 55, subpara. (c), and 72, subpara. (b)). Any additional sanctions aimed at protecting grantors against unauthorized registrations depend on the judgment in each State about the extent of the risk of unauthorized and fraudulent registrations relative to the cost of administering prescriptions of this nature (see the *Guide*, chap. IV, para. 20).

E. The role of the registry with respect to registered notices

73. The registry envisioned by the *Guide* is one that serves as a repository of information received by it, with the legal effect of that information determined by the substantive rules of the secured transactions regime. Accordingly, no information submitted by registrants would be subject to verification or substantive change by those administering the registry. Similarly, any changes in information that a registrant wishes to become part of the record would be submitted separately and would not have the effect of deleting any earlier-received information. In other words, change is not effected by deleting the currently registered information and replacing it with new one. Instead, an amendment is added to the registration so that the searcher will be able to find and examine both the originally registered information as well as the new information subsequently registered. Neither registrants nor registrars are able to replace any registered information, and registry systems should be programmed as such. All registrations are indexed in the registry database and may be removed only when their effectiveness is terminated or when they expire.