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Draft Guide to Enactment of the draft Model Law on Secured Transactions

Note by the Secretariat

Addendum

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Chapter V. Priority of a security right

A. General rules

Article 27. Competing security rights

1. Article 27 is based on recommendation 76 of the Secured Transactions Guide (see chap. V, paras. 45-54). It refers to third-party effectiveness (which requires creation and a third-party effectiveness act), while advance registration (i.e. registration before the creation of the security right or conclusion of the security agreement and thus before third-party effectiveness is achieved) is addressed in article 28.

2. As a general matter, priority between competing security rights is determined by the order in which the security rights became effective against third parties. Most often, third-party effectiveness of a security right created in accordance with the provisions of chapter II will be achieved by registration of a notice in the security rights registry (see art. 16). However, as detailed in chapter III, there are several other methods of achieving third-party effectiveness, the applicability of which depends on the nature of the encumbered asset and the secured transaction.

3. Notwithstanding the variety of acts that may achieve third-party effectiveness, however, the general rule in paragraph 1 determines priority unless one of the special rules in articles 28-37 is applicable. Thus, subject to those articles, paragraph 1 determines priority between competing security rights that were created by the same grantor and made effective against third parties by registration of a notice (i.e. where, for example, Grantor A creates a security right in its equipment in favour of secured creditor ("SC") 1 and then another security right in favour of SC 2). It also determines priority when one or both of the competing security rights were made effective against third-parties by another means.

4. Paragraph 2 is a new provision dealing with competing security rights created by different grantors (i.e. where, for example, Grantor A creates a security right in its equipment in favour of SC 1 and then transfers it to Transferee B who creates a security right in favour of SC 2). Under paragraph 2, priority is determined on the basis of the order of third-party effectiveness, provided that the secured creditor (SC 1) registers an amendment notice indicating the identifier of the transferee within a short period of time after the secured creditor becomes aware of the transfer or after the transfer (see art. 27, options A and B, of [the registry-related provisions]).

5. Paragraph 3 addresses situations in which there has been a change in the method of third-party effectiveness. This may happen, for example, where a secured creditor in possession of the encumbered asset returns possession of it to the grantor after registering a notice with respect to it in the security rights registry. In such a case, the priority of the security right is determined by the time at which the security right was first effective against third parties so long as there was no time thereafter during which the security right was not effective against third parties.

6. Paragraph 4, which is based on recommendation 100 of the Secured Transactions Guide (see chap. V, paras. 144-150), is of particular economic importance because the security right whose priority is being determined will often

be a security right in proceeds of the original encumbered asset. This is quite common when the original encumbered asset is inventory or a receivable inasmuch as the grantor frequently sells the inventory or collects the receivable before satisfaction of the obligation secured by the encumbered asset. In such a case, the security right continues in the proceeds as provided in article 10 and the security right in the proceeds is effective against third parties if the conditions in article 17 are satisfied. If those conditions are satisfied, under paragraph 4, the security right in the proceeds has the same priority as the security right in the original collateral. The rule in paragraph 4 is, however, limited by the special rule on the priority of security rights in proceeds of acquisition security rights in article 37.

7. Paragraphs 5-8 address priority issues resulting from situations in which one or both of the competing security rights is a security right that continued to a mass or product because the original encumbered asset was commingled in that mass or product (see Secured Transactions Guide, paras. 117-124).

[*Note to the Working Group: The Working Group may wish to consider whether illustrations of the operation of paragraphs 5-8 would be helpful*.]

Article 28. Competing security rights in the case of advance registration

8. Article 28 qualifies article 27, paragraph 1. While a security right cannot be effective against third parties unless it has been created in accordance with the provisions of chapter II, it is possible to register a notice in the Registry before the security right has been created. In such a case, article 28 provides that the priority of that security right as against other security rights is determined by the time of registration rather than the time of third-party effectiveness.

9. When combined with article 27, paragraph 1, article 28 creates a rule that brings about the following results: (a) as between security rights that were made effective against third parties by registration of a notice, priority is determined by the order of registration, regardless of the order of creation of the security rights; and (b) as between a security right that was made effective against third parties by registration and a security right that was made effective against third parties otherwise than by registration, priority is determined by the order of registration or third-party effectiveness, whichever occurs first. In both cases, when a security right has been the subject of a notice that was registered before the security right was created, it is the time of registration rather than the later time of third-party effectiveness that is used to determine priority.

10. To illustrate this rule, assume that: (a) on Day 1, Grantor authorizes SC 1 to register a notice listing Grantor as the grantor and describing the encumbered assets as all present and future equipment of Grantor and SC 1 registers the notice; (b) on Day 2, Grantor borrows money from SC 2 and grants SC 2 a security right in all of Grantor's present and future equipment, and SC 2 registers a notice with respect to this security right; and (c) on Day 3, Grantor borrows money from SC 1 and grants SC 1 a security right in all of Grantor's present and future equipment. In this case, the security right of SC 2 became effective against third parties before the security right of SC 1 (because a security right cannot be effective against third parties until it is created). Yet, as a result of article 28, the priority of SC 1's security right is determined by the time of registration of its notice. Thus, SC 1 will have priority

over SC 2 because SC 1's registration of the notice (on Day 1) occurred before the security right of SC 2 became effective against third parties.

11. This rule is beneficial for two reasons. First, as a result of this rule, the priority date for security rights that are made effective against third parties by the registration of a notice will always be determined by the time of registration. The time of registration is maintained by the Registry and is, therefore, easy to demonstrate and easy to search. By way of contrast, the creation of a security right is a private event between the grantor and the secured creditor; the time of creation is not maintained by the Registry and is not publicly available and may be difficult to establish.

12. Second, the results that follow from the application of the rule in this article are consistent with the behaviour of prudent secured creditors. For example, assume that SC 2 is considering extending credit to Grantor, secured by a security right in an item of Grantor's equipment. If SC 2 searches the records of the Registry and discovers that a notice has been registered listing Grantor as the grantor and SC 1 as the secured creditor and indicating that the encumbered asset is the same item of equipment, SC 2 will not know whether SC 1 has a security right or, rather, has registered a notice before creation of the security right. In such a situation, SC 2 would likely make the conservative assumption that the registered notice reflects an existing security right and, accordingly, if SC 2 decides to go forward with the transaction, it will be with the understanding that its rights are subordinate to that of SC 1. The rule in this article is consistent with the behaviour of SC 2.

[*Note to the Working Group: The Working Group may wish to note that, depending on the decision of the Working Group with respect to the contents of this article, the commentary may need to be revised*.]

Article 29. Rights of buyers or other transferees, lessees or licensees of an encumbered asset

13. Article 29 is based on recommendations 79-82 of the Secured Transactions Guide (see chap. V, paras. 60-89). It addresses situations in which the encumbered asset is sold or otherwise transferred, leased or licensed, and determines the rights of the buyer or other transferee, lessee or licensee vis-à-vis the security right.

14. The general rule, which is stated in paragraph 1 and is subject to important exceptions stated in paragraphs 2-6, is that a security right in an encumbered asset that is effective against third parties continues to encumber the asset notwithstanding the sale or other transfer, lease or license of the encumbered asset.

15. The article provides two types of exceptions to the general principle stated in paragraph 1. Paragraphs 2 and 3 provide exceptions based on the actions of the secured creditor, while paragraphs 4-6 provide exceptions based on the nature of the sale or other transfer, lease or licence and the knowledge of the buyer or other transferee, lessee or licensee.

16. Paragraphs 2 and 3 both give effect to authorizations of the secured creditor that protect the buyer or other transferee, lessee or licensee. The most common circumstances in which a secured creditor authorizes such a result are those in which the transaction will generate payment to the grantor that can be used to

satisfy the secured obligation, although the rule is not limited to those circumstances.

17. Paragraphs 4-6 protect a buyer, lessee, or licensee in ordinary course of business transactions from being subject to a security right that was effective against the third parties, provided that they acquired their rights without knowledge that the transaction violated the rights of the secured creditor under the security agreement. "Knowledge", as the term is used in paragraphs 4-6, is defined in article 2, paragraph (s), as actual knowledge. It is important to note that knowledge of the existence of the security right is insufficient to disqualify the buyer, lessee, or licensee from the benefits of paragraphs 4-6 (see art. 40 below).

18. Paragraphs 7 and 8 state what is often referred to as a "shelter principle" — once a buyer, lessee, or licensee obtains rights in the encumbered asset free of (or unaffected by) a security right, those that acquire their rights in the encumbered assets from or through the buyer, lessee, or licensee are similarly free of (or unaffected by) the security right.

Article 30. Rights of buyers or other transferees, lessees or licensees of an encumbered asset in the case of specialized registration

19. Article 30 is based on recommendations 77, subparagraph (a), and 78 of the Secured Transactions Guide (see chap. V, paras. 56 and 57). It is relevant only in States that provide a specialized registry or title certificate system for achieving third-party effectiveness of a security right in particular types of asset. Recommendation 77, subparagraph (b) of the Secured Transactions Guide is not reflected in this article on the understanding that the priority of rights registered in a specialized registry is a matter for the relevant specialized registration law.

20. In order to enable competing claimants that utilize the specialized registry or title certificate system to determine their rights solely by a search of the specialized registry or examination of the title certificate, article 30 provides rights to such parties that are superior to the rights of a secured creditor that achieved third-party effectiveness by other means.

21. In particular, a security right made effective against third parties through the specialized registry or title certificate system is superior to a security right made effective against third parties by any other means. Similarly, even if a security right in an encumbered asset is effective against third parties by a means other than registration in a specialized registry or notation on a title certificate, if the security right could have been made effective against third parties by such registration or notation, a buyer or other transferee, lessee, or licensee will acquire its rights free of, or unaffected by, the security right (for the coordination with specialized movable property registries, see Registry Guide, para. 64-70).

Article 31. Rights of the insolvency representative

[*Note to the Working Group: The Working Group may wish to note that the commentary to this article will be prepared if the Working Group decides to retain it*.]

Article 32. Preferential claims

22. Article 32 is based on recommendations 83, 85 and 86 of the Secured Transactions Guide (see chap. V, paras. 90-93 and 103-109). Its purpose is to implement the policy of these recommendations and give an enacting State an opportunity to: (a) list in a clear and specific way any statutory claims that may have priority over security rights; and (b) indicate a limitation on their amount. Examples of claims that may be listed in this article include claims of service providers and unpaid sellers or suppliers of goods but only to the extent that they have retained possession of the goods (see A/CN.9/830, para. 89). It should be noted that secured creditors typically obtain representations from grantors about preferential claims and otherwise address the possible existence of such claims.

23. This article applies outside insolvency. As the Model Law does not deal with insolvency matters, it does not include a similar rule for preferential claims in the case of the grantor's insolvency along the lines of recommendation 239 of the Secured Transactions Guide. In most States that require registration of a notice with respect to preferential claims, the priority of preferential claims is determined in the same way as the priority of security rights, that is, in other words, the general first-to-register priority rule applies. It should also be noted that, in the case of enforcement, if a preferential creditor does not take over the enforcement process (see art. 70), its claim will have to be paid ahead of the claims of secured creditors.

Article 33. Rights of judgement creditors

24. Article 33 is based on recommendation 84 of the Secured Transactions Guide (see chap. V, paras. 94-102). It determines the priority as between a security right in an encumbered asset and the rights of a judgement creditor that has acquired rights in the encumbered asset by taking certain steps. The enacting State will have to complete paragraph 1 by inserting the relevant step or steps necessary for a judgement creditor to acquire rights in the encumbered asset. These steps typically involve actions such as registration of a notice in the security rights registry, seizure of assets or service of a garnishment order.

25. Paragraph 1 gives priority to the judgement creditor if the steps necessary for it to acquire rights in the encumbered asset occur before the security right is made effective against third parties. In States that require registration of a notice with respect to these enforcement steps, the priority of the rights of judgement creditors is determined in the same way as the priority of security rights, that is, in other words, the general first-to-register priority rule applies.

26. Paragraph 2, however, provides that the priority of the rights of the judgement creditor does not extend to credit extended by the secured creditor within a short time after the judgement creditor notifies the secured creditor that it has taken the steps necessary to acquire its right, or to credit extended thereafter pursuant to an irrevocable commitment made before that notification. Paragraph 2 protects secured creditors against the possibility of inadvertently extending credit without realizing that their security rights are subordinate to the rights of a judgement creditor.

Article 34. Non-acquisition security rights competing with acquisition security rights

27. Article 34 is based on recommendations 180 of the Secured Transactions Guide (see chap. IX, paras. 131, 136, 137, 143 and 146) and recommendation 247 of the Intellectual Property Supplement (see paras. 259-263). Both option A and option B provide that, under certain circumstances, an acquisition security right has priority over a competing non-acquisition security right in the same encumbered asset even if, under the general priority rule in article 27, paragraph 1, the non-acquisition security right would have priority. When those circumstances are present, it is often said colloquially that the acquisition security right has "super-priority" over the competing non-acquisition security right.

28. "Super-priority" for acquisition security rights is a feature of the law of most States, whether phrased in terms of a higher priority for security rights securing obligations incurred in acquiring the encumbered asset or, more traditionally, as a result of title to the encumbered asset being retained by the seller or other acquisition financier. Article 34 continues this practice, providing a variety of "super-priority" rules depending on the nature of the asset that is subject to the acquisition security right.

29. Option A contains three "super-priority" rules. Which of the three rules is applicable in a particular case depends on the nature of the encumbered assets. If the encumbered assets are inventory, or intellectual property or rights of a licensee under a licence of intellectual property held by the grantor [primarily] for sale or licence in the ordinary course of the grantor's business, the rule in subparagraph (1)(b) applies. If the encumbered assets are consumer goods, intellectual property or rights of a licensee under a licence of intellectual property used or intended to be used by the grantor [primarily] for personal, family or household purposes, the rule in subparagraph (1)(c) applies. In all other cases, the rule in subparagraph (1)(a) applies.

30. Under the general "super-priority" rule in subparagraph (1)(a), an acquisition security right has priority over a competing non-acquisition security right created by the grantor, if either the acquisition secured creditor is in possession of the asset (unlikely inasmuch as most acquisition security rights are non-possessory) or a notice with respect to the acquisition security right is registered in the Registry within a short period of time to be specified by the enacting State after the grantor obtains possession of the asset. Thus, so long as the acquisition secured creditor registers a notice with respect to the acquisition security right within the specified period, that security right will have priority over a competing non-acquisition security right that was made effective against third parties before the acquisition security right was made effective against third parties.

31. Under the super-priority rule in subparagraph (1)(b), additional requirements must be satisfied for an acquisition secured creditor that does not have possession of the encumbered assets to have "super-priority" over a competing non-acquisition security right. In particular, before the grantor obtains possession of the encumbered asset, a notice with respect to the acquisition security right must be registered and, in addition, a notice must be received by the non-acquisition secured creditor (if the non-acquisition secured creditor has registered a notice in the Registry with respect to a security right created by the grantor in an asset of the same kind), stating that

the acquisition secured creditor has or intends to acquire an acquisition security right and describing the asset sufficiently to enable the non-acquisition secured creditor to identify the asset that is the object of the acquisition security right. Under the super-priority rule in subparagraph (1)(c), an acquisition security right automatically has priority over a non-acquisition security right in the same encumbered asset.

32. Option B contains only two "super-priority" rules. One of the rules (subparagraph (b)) applies when the encumbered assets are consumer goods, or intellectual property or rights of a licensee under a licence of intellectual property used or intended to be used by the grantor [primarily] for personal, family or household purposes. That "super-priority" rule is identical to the rule in option A, subparagraph (1)(c). For those types of encumbered asset, an acquisition security right automatically has priority over a non-acquisition security right in the same encumbered asset. The other "super-priority" rule in option B (subparagraph (a)) is identical to the rule in option A, subparagraph (1)(a). Thus, the only difference between option A and option B is that, in the former, extra steps must be taken in order for an acquisition security right in inventory, or in intellectual property or rights of a licensee under a licence of intellectual property held by the grantor [primarily] for sale or licence in the ordinary course of the grantor's business, to have priority over a competing non-acquisition security right.

33. The prerequisites to "super-priority" in option A, subparagraphs (1)(a) and (1)(b), and option B, subparagraph (a), are present to provide some protection to competing secured creditors whose security rights are effective against third parties before the third-party effectiveness of the acquisition security right. By providing a means by which the non-acquisition secured creditor can determine that newly-acquired assets are subject to an acquisition security right (either by registration of a notice shortly after the grantor's acquisition of the asset (see option A, subparagraph (1)(a), and option B, subparagraph (a)) or by a notice to the acquisition secured creditor (see option A, subparagraph (1)(b)), the non-acquisition secured creditor can assess its economic position more accurately and make informed decisions as to whether to extend additional credit. The main difference in this regard is that under option A the non-acquisition secured creditor will receive a notice only for some types of encumbered asset (primarily inventory, see art. 34(1)(b)) and thus may have to conduct a search before every advance secured by another type of asset, while under option B the non-acquisition secured creditor will receive a notice from the acquisition secured creditor for most types of encumbered asset (all but consumer goods).

Article 35. Competing acquisition security rights

34. Article 35 is based on recommendation 182 of the Secured Transactions Guide (see chap. IX, paras. 173-178). It addresses the priority of competing security rights when both are acquisition security rights. Unlike article 34 (which gives priority to acquisition security rights that satisfy certain criteria as against non-acquisition security rights), this article addresses priority as between security rights both of which would otherwise be entitled to "super-priority". The article reflects two policy decisions. First, an acquisition security right of a seller or lessor, or a licensor of intellectual property, has priority over an acquisition security right of another person such as a lender. Second, in all other cases, priority between acquisition

security rights should be determined on the basis of rules applicable when neither are acquisition security rights.

Article 36. Acquisition security rights competing with the rights of judgement creditors

35. Article 36 is based on recommendation 183 of the Secured Transactions Guide (see chap. IX, paras. 145-148). Without the rule in this article, the period provided in article 34 would not be useful. The reason for this is that a secured creditor taking an acquisition security right typically would not want to have a period in which it would be vulnerable to the rights of a judgement creditor. In such a case, a secured creditor would likely register a notice before, or as soon as possible after, the security right was created. Accordingly, a secured creditor would not benefit from the longer period to register and achieve "super-priority" under article 34.

36. By way of illustration, assume that Grantor acquires an item of equipment from Seller on credit on Day 1 and grants Seller an acquisition security right in the item of equipment to secure its obligation to pay the remainder of the purchase price; on Day 5 Seller registers a notice that has the effect of making its acquisition security right effective against third parties. Between those two dates, on Day 3, Judgement Creditor obtains a judgement against Grantor and takes the steps specified in article 33, paragraph 1, to acquire rights in the item of equipment. Under the rule in article 33, paragraph 1, Judgement Creditor's rights would have priority over Seller's security right because Judgement Creditor obtained its rights before Seller's security right was effective against third parties. As a result of the operation of article 36, however, Seller's security right has priority over the rights of Judgement Creditor.

Article 37. Acquisition security rights in proceeds

37. Article 37 is based on recommendation 185 of the Secured Transactions Guide (see chap. IX, paras. 158-172). Both option A and option B of article 34 provide that, under certain circumstances, an acquisition security right has priority over a competing non-acquisition security right in the same encumbered asset even if, under the general priority rule in article 27, paragraph 1, the non-acquisition security right would have priority. This article determines whether that "super-priority" over non-acquisition security rights carries over to proceeds of the encumbered assets that are subject to the acquisition security right.

38. Under the general principles of article 10, a secured creditor with a security right in an asset obtains a security right in the identifiable proceeds of that asset and, under the circumstances described in article 17, that security right is effective against third parties. This is equally true of assets subject to non-acquisition security rights and those subject to acquisition security rights. Under the general priority rule in article 27, paragraph 4, the priority of the security right in the proceeds is the same as the priority of the security right in that asset. Under that rule, the security right in proceeds of assets subject to an acquisition security right would have the same "super-priority" as the security right in the original asset. Article 37, however, limits the reach of article 27, paragraph 4, by extending "super-priority" to proceeds only of certain types of assets subject to an acquisition security right (option A) or by not extending the "super-priority" to proceeds at all (option B).

39. Under option A, the "super-priority" with respect to assets subject to an acquisition security right carries over to proceeds of those assets in certain circumstances and does not carry over in other circumstances. More particularly, option A provides that the "super-priority" with respect to the assets subject to the acquisition security right always carries over to the proceeds of those assets, except when the assets subject to the acquisition security right consist of: (a) inventory; (b) consumer goods; or (c) intellectual property or rights of a licensee under a licence of intellectual property held by the grantor [primarily] for sale or licence in the ordinary course of the grantor's business or used or intended to be used by the grantor [primarily] for personal, family or household purposes. When the asset subject to the acquisition security right is inventory, or intellectual property or rights of a licensee under a licence of intellectual property held by the grantor [primarily] for sale or licence in the ordinary course of the grantor's business, whether the "super-priority" carries over to proceeds depends on the nature of the proceeds. If the proceeds are receivables, negotiable instruments, or rights to payment of funds credited to a bank account, the "super-priority" does not carry over to those proceeds. If, on the other hand, the proceeds take another form, the "super-priority" does carry over to the proceeds. When the assets subject to the acquisition security right are consumer goods or intellectual property or rights of a licensee under a licence of intellectual property used or intended to be used by the grantor [primarily] for personal, family or household purposes, however, the "super-priority" does not carry over to the proceeds.

40. The primary reason for the decision not to provide "super-priority" for certain types of proceeds in option A relates to the difficulty that would be faced by competing secured creditors with security rights in payment rights in determining which of those payment rights are proceeds of assets subject to acquisition security rights and which are not. As a result, if there were "super-priority" treatment for those types of proceeds, competing secured creditors with security rights in payment rights might simply assume that all of those payment rights are proceeds and, as a result, extend less credit on the basis of them.

41. Option B provides that the "super-priority" with respect to assets subject to an acquisition security right does not carry over to proceeds of those assets under any circumstances, with the result that the priority of the security right in the proceeds will be determined under the general principle in article 27. This option is provided as an option for States that do not wish to make the sort of distinctions between types of proceeds made in option A.

42. As the Model Law does not deal with insolvency-related matters, with the exception of article 31, no article has been included in the Model Law along the lines of recommendation 186 of the Secured Transactions Guide to deal with the application of the special priority rules for acquisition security rights. However, there is nothing in these articles to imply that insolvency law will not operate against the background of secured transactions law and thus that these provisions will not apply to acquisition security rights in the case of insolvency.

Article 38. Subordination

43. Article 38 is based on recommendation 94 of the Secured Transactions Guide (see chap. V, paras. 128-131). Paragraph 1 allows a person to agree to lower priority

of its security right as against a competing claimant than would otherwise result from application of the priority rules in this Chapter.

44. Such an agreement, usually referred to as a subordination agreement, may be in the form of a bilateral agreement between the party agreeing to lower priority and the competing claimant that will benefit from that agreement; it may also be a unilateral commitment (usually made to the grantor) by the party agreeing to lower priority that its priority will be lower than that of the beneficiaries described in the commitment. Such an agreement is governed by this article so long as it is between a secured creditor and a grantor, between two or more secured creditors or between a secured creditor and another competing claimant (e.g. a judgement creditor or an insolvency representative).

45. Paragraph 2 makes it clear that a subordination agreement affects only the parties to it and any other beneficiaries of the subordination. For example, if SC 1, that has a claim for 50, subordinates its claim to SC 3, who has a claim for 70, SC 3 has priority over SC 2 only for 50.

46. In unusual circumstances, subordination can create circular priority issues. For example, assume that SC 1, 2, and 3 each have a security right in the same encumbered asset and their priority, determined under the rules of this chapter, is in that order, so that SC 1's security right is superior to that of SC 2 and SC 2's security right is, in turn, superior to that of SC 3. Then assume that SC 1 enters into a subordination agreement with SC 3, pursuant to which SC 1 agrees to subordinate its priority in favour of SC 3. As a result, SC 3 has priority over SC 1. However, SC 1 (who did not subordinate its priority in favour of SC 2) has priority over SC 2, and SC 2 has priority over SC 3, completing the circle.

Article 39. Future advances, future encumbered assets and maximum amount

47. Article 39 is based on recommendations 97-99 of the Secured Transactions Guide (see chap. V, paras. 135-143). Not all secured transactions involve a single extension of credit that is secured by encumbered assets in which the grantor has rights at the outset of the transaction. Rather, article 7 provides that the parties may agree that the encumbered assets will secure not only the obligation created contemporaneously with the security agreement but also any subsequent obligation of the grantor to the secured creditor; and article 8 provides that the parties may agree that assets created or acquired by the grantor after the security agreement is entered into will also secure the indebtedness.

48. Paragraphs 1 and 2 of this article provide that the priority of security rights so created extends to those subsequent obligations and after-acquired assets. Paragraph 3, which will be necessary only if the enacting State enacts provisions based on article 6, subparagraph 3(e), and article 9, subparagraph (e) [of the registry-related provisions], gives effect to any cap on the secured obligation stated in the notice by providing that the secured creditor's priority is limited by that cap.

Article 40. Irrelevance of knowledge of the existence of a security right

49. Article 40 is based on recommendation 93 of the Secured Transactions Guide (see chap. V, paras. 125-127). Knowledge or lack of knowledge of a security right by a competing secured creditor is not relevant to a determination of priority under either the general priority rule in article 27 or any of the special priority rules. The

point is made explicit here to emphasize that priority is determined only on the basis of the objective facts referred to in those articles and not on the basis of difficult to prove subjective states of knowledge. However, article 40 does not go as far as to treat as irrelevant the knowledge on the part of, for example, a buyer of an encumbered asset, that the sales agreement violates the rights of the secured creditor under the security agreement (see art. 29, paras. 4-6, art. 41, para. 2(c), art. 42, para. 6, and art. 43, para. 1).

B. Asset-specific rules

Article 41. Negotiable instruments

50. Article 41 is based on recommendations 101 and 102 of the Secured Transactions Guide (see chap. V, paras. 154-156). Any drafting changes are intended to ensure that paragraph 1 deals only with the relative priority of conflicting security rights in the same negotiable instrument, while paragraph 2 addresses the rights of a secured creditor with a security right in a negotiable instrument as against a buyer or other consensual transferee of the negotiable instrument (see A/CN.9/830, para. 49).

51. Under paragraph 1, a security right in a negotiable instrument that is made effective against third parties by the secured creditor's possession of the negotiable instrument has priority over a security right in the same negotiable instrument that is made effective against third parties by registration of a notice, without regard to the order in which the security rights became effective against third parties. This is consistent with the important role that possession plays in the law of negotiable instruments.

52. Under paragraph 2, certain buyers or other transferees that take possession of a negotiable instrument take their rights in the instrument free of a security right that is effective against third parties by registration of a notice (if the security right were effective against third parties because of the secured creditor's possession of the negotiable instrument, the buyer or other transferee could not also have possession of it, unless the same agent possesses the negotiable instrument both on behalf of the secured creditor and the buyer or other transferee).

53. The parties that take free under this rule are a protected holder of the negotiable instrument (see subpara. 2(a), which refers the exact formulation of this concept to the enacting State) or a transferee that takes possession of the instrument and gives value for it without knowledge that the sale or other transfer is in violation of the rights of the secured creditor (see subpara. 2(b)). As with the rule in paragraph 1, this rule preserves the important role of possession in the law of negotiable instruments.

54. Knowledge of the existence of a security right does not prevent a buyer or other transferee of a negotiable instrument from acquiring its rights in the instrument free of the security right. Rather, it is only knowledge that the transfer violates the rights of the secured creditor under the security agreement that prevents the transferee from taking free. "Knowledge", as defined in article 2, paragraph (s), means "actual knowledge". The reference to "good faith" that was included in recommendation 102, subparagraph (b) has been deleted on the understanding that

the absence of knowledge amounts essentially to good faith and the concept of good faith is used in the draft Model Law only to reflect an objective standard of conduct (see A/CN.9/830, para. 50).

Article 42. Rights to payment of funds credited to a bank account

55. Article 42 is based on recommendations 103-105 of the Secured Transactions Guide (see chap. V, paras. 157-163). It determines the priority between competing security rights in a right to payment of funds credited to a bank account whether those rights to payment are original encumbered assets or proceeds of a security right in other property (which, according to art. 17, para. 1, is automatically effective against third parties, if the security right in the original encumbered asset is effective against third parties).

56. Paragraph 1 provides that a security right in a right to payment of funds credited to a bank account made effective against third parties by any of the methods foreseen in article 23 has priority over a security right made effective against third parties by registration of a notice. Under paragraphs 2 and 3, as among security rights in a right to payment of funds credited to a bank account that have been made effective against third parties by one of those alternative methods, a security right made effective against third parties by the secured creditor becoming the account holder has the highest priority, followed by a security right made effective against third parties as a result of the secured creditor being the depositary bank. Under paragraph 4, if there are more than one control agreements, priority is determined on the basis of the order of conclusion of the control agreements.

57. Under paragraph 5, except when the secured creditor has become the account holder, a security right in a right to payment of funds credited to a bank account will be subordinate to the depositary bank's rights of set-off (that are subject to other law) for debts owed to the depositary bank by the grantor. This protects depositary banks against losing their rights of set-off without their knowledge or consent.

58. Under paragraph 6, a transferee of funds from a bank account pursuant to a transfer initiated or authorized by the grantor acquires its rights free of a security right in the right to payment of funds credited to the bank account so long as the transferee does not have knowledge that the transfer violates the rights of the secured creditor under the security agreement. A "transfer of funds" includes transfers by a variety of mechanisms, including by cheque and electronic means. The purpose of paragraph 7 is to preserve the free negotiability of funds.

59. Knowledge of the existence of a security right does not prevent a transferee of funds from the bank account from taking free of the security right. Rather, it is only knowledge that the transfer violates the rights of the secured creditor under the security agreement that prevents the transferee from taking free. "Knowledge", as defined in article 2, paragraph (s), means "actual knowledge".

Article 43. Money

60. Article 43 is based on recommendation 106 of the Secured Transactions Guide (see chap. V, para. 164). Its purpose is to preserve negotiability of money. Thus, under paragraph 1, a transferee of encumbered money acquires its rights in it free of the security right, unless it has knowledge that the transfer violates the rights of the secured creditor under the security agreement. "Knowledge", as defined in article 2,

paragraph (s), means "actual knowledge". Paragraph 2 is intended to preserve the free negotiability of money.

Article 44. Negotiable documents and tangible assets covered

61. Article 44 is based on recommendations 108 and 109 of the Secured Transactions Guide (see chap. V, paras. 167-169). It is designed to preserve current practices under which rights to the tangible assets covered (or represented) by a negotiable document are subsumed in the negotiable document with the result that parties that deal with the document generally need not concern themselves separately with claims to the assets not reflected in the document. Accordingly, under paragraph 1, a security right in a tangible asset made effective against third parties by possession of the negotiable document covering that asset is given priority over a competing security right made effective against third parties by any other means.

62. Paragraph 2 states an exception to that general rule. Except when the encumbered asset is inventory, it provides that the rule in paragraph 1 does not apply against a secured creditor that had a security right in an encumbered asset before the earlier of the time that either the asset became covered by the negotiable document or the time that an agreement was concluded between the grantor and the secured creditor in possession of the negotiable document providing that the asset was to be covered by a negotiable document so long as the asset actually became covered by such a negotiable document within the time to be specified by the enacting State.

Article 45. Intellectual property

63. Article 45 is based on recommendation 245 of the Intellectual Property Supplement (see paras. 193-212). The purpose of this article is to clarify that the rule in article 29, paragraph 6, does not obviate other rights of the secured creditor as an owner or licensor of the intellectual property that is the subject of the license. This clarification is of particular importance because the concept of "ordinary course of business", used in article 29, paragraph 6, is a concept of commercial law and is not drawn from law relating to intellectual property law and thus may create confusion in an intellectual property financing context. Typically, law relating to intellectual property does not distinguish in this respect between exclusive and non-exclusive licences and focuses rather on the issue of whether a licence has been authorized or not.

64. As a result, unless the secured creditor authorized the grantor to grant licences unaffected by the security right (which will typically be the case as the grantor will rely on its royalty income to pay the secured obligation), the licensee would take the licence subject to the security right. Thus, if the grantor defaults, the secured creditor would be able to enforce its security right in the licensed intellectual property and sell or license it free of the licence. In addition, a person obtaining a security right from the licensee will not obtain an effective security right as the licensee would not have received an authorized licence and would have no right in which to create a security right.

Article 46. Non-intermediated securities

65. Article 46 covers a topic not addressed in the Secured Transactions Guide, which excluded all types of securities (see rec. 4, subpara. (c)). So as not to interfere with existing customs and practices with respect to non-intermediated securities, this article adapts the general priority rule of article 27 in a manner similar to the special priority rules for security rights in negotiable instruments and rights to payment of funds credited to a bank account.

66. For certificated non-intermediated securities, paragraph 1 provides that a security right made effective against third parties by the secured creditor's possession of the certificate has priority over a competing security right by the same grantor that is made effective against third parties by registration of a notice in the Registry (this is parallel to the rule for negotiable instruments in art. 41, para. 1).

67. For uncertificated non-intermediated securities, paragraph 2 provides that notation of a security right or registration of the name of the secured creditor as the holder of the securities in the books maintained for that purpose (by the issuer or someone else on behalf of the issuer) fulfils a similar function to the secured creditor becoming the account holder of a bank account (this rule is similar to the rule for rights to payment of funds credited to a bank account in art. 42, para. 1).

68. Paragraphs 3 and 4 are also applicable only to uncertificated non-intermediated securities (they parallel the similar rules for rights to payment of funds credited to a bank account in art. 42, paras. 3 and 4). Paragraph 3 gives priority to a security right made effective against third parties by conclusion of a control agreement over other security rights in the same securities. As between security rights made effective against third parties by conclusion of a control agreement, paragraph 4 awards priority in the order in which those control agreements were concluded.

[*Note to the Working Group: The Working Group may wish to note that discussion of paragraph 5 will be inserted once the Working Group has had the opportunity to consider it and reach an agreement as to its contents*.]