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## Security Interests

### Recommendations of the draft Legislative Guide on Secured Transactions

#### Report of the Secretary General

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## **Recommendations of the draft Legislative Guide on Secured Transactions**

### **I. Scope**

#### **Purpose**

1. The purpose of the scope provisions of the secured transactions law (hereinafter referred to as “the law”) should be to specify the parties, the security rights, the secured obligations and the assets to which the law applies.

#### **Security rights**

2. The law should deal with security rights in movable property and fixtures securing payment or other performance of one or more obligations, present or future, determined or determinable.

#### **Parties, security rights, secured obligations and assets covered**

3. The scope of the law should be as broad as possible with respect to the parties, and the types of security rights, secured obligations and encumbered assets covered. Any exceptions should be limited and clearly stated in the law.

4. In particular, the law should apply to:

(a) legal and natural persons, including consumers;

(b) rights created contractually to secure all types of obligations, including future obligations, fluctuating amounts of obligations and obligations described in a generic way;

(c) all types of movable assets and fixtures, tangible or intangible, not specifically excluded in the law, including inventory, equipment and other goods, receivables, [cheques, promissory notes, deposit accounts, letters of credit and intellectual property rights], as well as proceeds of those assets; [*Note to the Working Group: If the Working Group decides that such types of asset should be covered in the draft Guide, it may wish to review the recommendations to ensure that they are appropriate for those assets as well and to add special recommendations where necessary.*]

(d) rights in all assets of a grantor; and

(e) security by way of transfer of title [and all other types of rights securing the payment or other performance of one or more obligations, irrespective of the form of the relevant transaction and whether ownership of the encumbered assets is held by the secured creditor or the grantor]. [*Note to the Working Group: The Working Group may wish to consider: (i) including retention of title in the legislative regime recommended and give it preferential treatment for priority or other purposes; (ii) exclude at least simple retention of title from*

*the legislative regime recommended but subject it, with some exceptions, to registration for the purpose of addressing priority conflicts; (iii) exclude at least simple retention of title, from the legislative regime recommended. See also Recommendations 10, 27, 43, 72, 76, 82 and 86.]*

5. The law should not apply to security rights in:
  - (a) securities; and
  - (b) [...].

## II. Creation

### Purpose

6. The purpose of the provisions of the law dealing with creation is to specify the way in which a security right in movable property is created as between the grantor and the secured creditor.

### Security agreement

7. The law should specify that a security right is created as between the grantor and the secured creditor by security agreement.

### Delivery of possession

8. The creation of a possessory security right requires, in addition to agreement, the delivery of possession of the assets to be encumbered to the secured creditor or another third party who holds the assets on behalf of the secured creditor (other than the grantor or an agent or employee of the grantor) (see recommendation 28).

### Minimum contents of the security agreement

9. The law should provide that the security agreement must, at a minimum, identify the secured creditor and the grantor and reasonably describe the secured obligation and the assets to be encumbered. A generic description of the secured obligation and the encumbered assets should be sufficient.

### Form

10. The law should provide that the security agreement must be in writing which need not be signed as long as the intention of the grantor to grant a security right is clearly reflected in the document [*Note to the Working Group: The Working Group may wish to limit the writing requirement to non-possessory security. The Working Group may also wish to exclude simple retention of title, from the writing requirement.*]

11. The law should specify that a data message may satisfy the requirement of a writing provided that the information contained therein is accessible so as to be usable for subsequent reference (see article 6 of the UNCITRAL Model Law on Electronic Commerce). “Data message” means information generated, sent received or stored by

electronic, optical or similar means, including, but not limited to, electronic data interchange (EDI), electronic mail, telegram, telex or telecopy (see article 2 (a) of UNCITRAL Model Law on Electronic Commerce).

#### **Assets and obligations subject to a security agreement**

12. The law should make it possible to secure all types of obligations, including future obligations and fluctuating amounts of obligations. It should also make it possible to provide security in all types of asset, including fixtures and accessions, as well as in assets which the grantor may not own or have the power to dispose of, or which may not exist at the time of the security agreement, and in proceeds. Any exceptions to these rules should be limited and described clearly in the law.

#### **Time of creation**

13. The law should provide that a possessory security right is created at the time the grantor delivers possession or control of the assets to be encumbered to the secured creditor or another third person who holds the assets on behalf of the secured creditor (other than the grantor or an agent or employee of the grantor), unless the parties otherwise agree. A non-possessory security right is created at the time the security agreement is made, unless the parties otherwise agree. A security right in future property is created at the time the debtor or other grantor acquires rights in such property.

### **III. Third party effectiveness**

#### **Purpose**

14. The purpose of the provisions of the law requiring an additional step before a security right may be asserted against competing claimants is:

- (a) to alert third persons dealing with the movable assets of the grantor of the risk that those assets may be encumbered by a security right; and
- (b) to provide a temporal event for ordering priority among secured creditors and between a secured creditor and other classes of competing claimants.

#### **Methods for achieving third party effectiveness**

15. The law should provide that a security right may be asserted against a competing claimant only when one of the following events occurs:

- (a) registration of a notice of the security right in a general security rights registry;
- (b) dispossession of the grantor if the encumbered assets are specific items of tangible movable property;
- [(c) transfer of control to the secured creditor if the encumbered assets are [certain intangible obligations, other than receivables, owing to the grantor by a third person] [a deposit account];]

(d) registration of a notice of the security right in a specialized title registry if the encumbered assets are specific items of movable property for which title is established, under other law of the enacting State, by registration in such a registry; or

(e) entry of a notation of the security right on the title certificate if the encumbered assets are specific items of tangible movable property for which, under other law of the enacting State, title is evidenced by a title certificate.

16. The law should confirm that different methods for achieving third party effectiveness may be used for different items or kinds of encumbered assets whether or not they are encumbered by the same security agreement or by separate security agreements.

#### **Establishment and characteristics of a general security rights registry**

17. The law should provide for the establishment of a general security rights registry having the following characteristics:

(a) registration is effected by filing a notice of the security right as opposed to a copy of the security documentation;

(b) the record of the registry is centralized; that is, it contains all notices of security rights registered under the secured transactions law of the enacting State;

(c) the registration system is set up to permit the indexing and retrieval of notices according to the name of the grantor or according to some other reliable identifier of the grantor;

(d) the registry is open to the public;

(e) reasonable public access to the registry is assured through such measures as:

(i) setting fees for registration and searching at a cost-recovery level; and

(ii) making available remote modes or points of access;

(f) The registration system is administered and organized to facilitate efficient registration and searching. In particular:

(i) a notice may be registered without verification or scrutiny of the sufficiency of its content;

(ii) subject to the financial and infrastructural capacity of the enacting State, notices are stored in electronic form in a computer data base;

(iii) subject to the financial and infrastructural capacity of the enacting State, registrants and searchers have electronic access to the registry record, or telephone or teletype access; and

(g) the law provides rules on the allocation of liability for loss or damage caused by an error in the administration or operation of the registration and searching system

#### **Required content of registered notice**

18. To constitute a legally effective registration, the law should require the registered notice to contain [only]:

(a) the names (or other reliable identifiers) of the grantor and the secured creditor, and their addresses;

(b) a description of the movable property covered by the notice;

[(c) the term of the registration [if the State elects to allow registrants to self-select the number of years for which the registration is to be effective] [see Recommendation 25]; and

[(d) a statement of the maximum monetary amount for which the security right may be enforced.]

#### **Legal sufficiency of grantor name in a registered notice**

19. The law should provide that the name or other identifier of the grantor entered on a registered notice is legally sufficient if the notice can be retrieved by searching the registry record according to the correct legal name or other identifier of the grantor. For this purpose, the law should specify rules for determining the correct legal name or other identifier of individuals and entities.

#### **Legal sufficiency of description of assets covered by a registered notice**

20. The law should provide that a description of the assets covered by a registered notice is legally sufficient if it enables a third person to identify the assets covered by the notice separate from other assets of the grantor.

21. If the assets covered by the notice consist of a generic category or categories of movable property, the law should confirm that a generic description is legally sufficient.

22. If the assets covered by the notice are all the present and after-acquired movable property of the grantor, the law should confirm that it is legally sufficient to describe the charged assets as “all movable property” or by using equivalent language.

#### **Advance registration**

23. The law should confirm that a registration may be made before or after the creation of the security right to which it relates.

### **One registration for multiple security agreements**

24. The law should confirm that a single registration is sufficient for security rights created by all security agreements entered into between the same parties to the extent they cover items or kinds of movable property that fall within the description contained in the registered notice.

### **Duration and renewal of registration**

25. The law should specify the duration of registration or permit the duration to be selected by the registrant at the time of registration. The law should provide for the right to successively renew the term of a registration.

### **Discharge of registration**

26. The law should adopt a summary procedure to enable the grantor to compel discharge of a registration if no security agreement has been completed between the parties or if the security right has been terminated by full payment or performance of all of the secured obligations.

### **[Additional rights subject to registration]**

27. The law should provide that the following rights may be asserted against third parties only if notice of the right is registered in the general security rights registry:

[(a) the title of a creditor who retains title to goods to secure payment of the purchase price of the goods or its economic equivalent under an agreement of sale or a financing lease;] and

[(b) the title of:

(i) a lessor under a lease that is not a financing lease but which extends for a term of more than one year;

(ii) an assignee under an outright assignment [sale] of receivables;

(iii) a consignor under a commercial consignment in which the goods are consigned to a consignee as agent for sale other than an auctioneer and other than a consignee who does not act as a consignee in the ordinary course of business;

(iv) a buyer under a sale of goods outside the ordinary course of the seller's business where the seller remains in possession of the goods for more than [thirty] [sixty] [ninety] days; and

(v) a transferee under a transfer of title for security purposes.]

### **Dispossession of the grantor**

28. The law should provide that:

(a) dispossession of the grantor is sufficient only if an objective third person can conclude that the encumbered assets are not in the actual possession of the grantor; and

(b) possession by a third person constitutes sufficient dispossession only if the third person is not an agent or employee of the grantor and holds possession for or on behalf of the secured creditor.

### **Negotiable instruments**

29. The law should provide that dispossession of a negotiable document of title constitutes dispossession of the assets represented by the document during the time that the assets are covered by the document.

### **[Transfer of Control over [Intangible Obligations] [Deposit Accounts]**

30. The law should provide that a [person who owes a certain intangible obligation to the grantor] [a depository institution with whom the grantor has a deposit account] is required to respond, within a [prescribed] [reasonable] time, to a written demand from a creditor of the grantor for confirmation of whether control over [the performance of the intangible obligation] [the deposit account] has been transferred to a creditor of the grantor.

31. If the secured creditor and the [person owing the intangible obligation] [the depository institution] are the same person, the law should confirm that the secured creditor acquires control as soon as the security right is created.]

### **Security rights in proceeds**

32. Where the law recognizes a statutory security right in the identifiable proceeds of the originally encumbered assets, the law should provide that the security right takes effect against third parties as soon as the proceeds arise provided that:

(a) the proceeds take the form of money, negotiable instruments, negotiable documents of title, or receivables [including] [and] deposit accounts;

(b) the proceeds are covered by the description contained in a notice registered in the general security rights registry; or

(c) the security right in the proceeds is independently made effective against third parties by one of the methods referred to in recommendation 15 within [...] days after the proceeds arise.

## **IV. Priority**

### **Purpose**

33. The purpose of the provisions of the law on priority is to:



- (a) enable a potential secured creditor to determine, in an efficient manner and with a high degree of certainty prior to extending credit, the priority that the security rights would have relative to competing claimants; and
- (b) enable grantors to create more than one security right in the same asset and to thereby use the full value of their assets to facilitate obtaining credit.

### **Scope of priority rules**

34. The law should have a complete set of priority rules covering all possible priority conflicts.

### **Secured obligations affected**

35. The law should provide that the priority accorded to a security right:
- (a) extends to all secured monetary and non-monetary obligations owed to the secured creditor [up to a maximum monetary amount set forth in the registered notice] and secured by the security right, including principal, costs, interest and fees; and
  - (b) is unaffected by the date on which an advance or other obligation secured by the security right is made or incurred (i.e. a security right may secure future advances under a credit facility with the same priority as advances made under the credit facility contemporaneously with the creation or completion of the security right).

### **Priority in after-acquired property**

36. The law should specify that a security right in after-acquired or after-created assets of the grantor has the same priority as a security right in assets of the grantor owned or existing at the time the security right is made effective against third parties.

### **Priority in proceeds**

37. The law should provide that a secured creditor's priority with respect to an encumbered asset extends to the proceeds of the asset subject to the requirements of recommendation 32.

### **Priority in the case of a change in method for achieving third party effectiveness**

38. The law should provide that if, while a security right is made effective against third parties by one method, it is also made effective against third parties by another method, priority dates as of the time the first method is completed [provided that there was no time gap between completion of the first and the second method].

### **Priority of security rights that are not effective against third parties**

#### **Unsecured creditors**

39. The law should provide that a secured creditor with a security right that is not effective against third parties has [no right other than an unsecured creditor] [priority

over unsecured creditors unless the unsecured creditor has taken steps to reduce its claim to a judgement or the grantor has become insolvent].

#### **Secured creditors**

40. The law should provide that:

(a) a security right that is not effective against third parties is subordinate to a security right in the same encumbered assets that is effective against third parties, without regard to the order in which the security rights were created; and

(b) priority among security rights that are not effective against third parties is determined by the order in which they were created.

#### **Priority of security rights that are effective against third parties**

##### **Unsecured creditors**

41. The law should provide that a security right that is effective against third parties has priority over the rights of unsecured creditors.

##### **Secured creditors**

42. The law should provide that:

(a) as between two security rights in the same encumbered asset that are effective against third parties, except as provided in recommendation 4, priority is determined by the order in which their respective third party effectiveness steps occurred, even if one or more of the requirements for the creation of a security right was not satisfied at such time. If one of the security rights is made effective against third parties by possession of the encumbered asset, the holder of that security right will have the burden of establishing when it obtained possession;

(b) a security right made effective against third parties by control has priority over a security right made effective against third parties by any other method;

(c) with respect to negotiable instruments, negotiable documents and money, a security right made effective against third parties by possession or control has priority over a security right made effective against third parties by registration.

#### **Purchase money security rights**

43. The law should provide that:

(a) a purchase money security right in goods that has been made effective against third parties by registration within a short specified period after the grantor obtains possession of the goods has priority over a competing non-purchase money security right in the same goods that has been made effective

against third parties by prior registration[. Retention of title arrangements should be subject to the same requirements as purchase money security rights]; and

[(b) if the goods subject to a purchase money security right consist of inventory, then, in addition to registration, the law should require that the purchase money creditor give notice before delivery of the goods to the grantor to all other creditors who have previously registered a security right in the same goods in order to obtain priority over those creditors.]

### **Judgement creditors**

44. The law should provide that, if applicable law gives a judgement creditor rights in assets of the judgement debtor in recognition of the legal steps the judgement creditor has taken to enforce its claims, a security right that is effective against third parties has priority over the right of the judgement creditor that is registered after the security right has become effective against third parties, except with respect to amounts advanced by the secured creditor subsequent to a specified number of days after the date on which the judgement creditor registers a notice of its rights.

### **Buyers of encumbered assets**

45. The law should provide that the right of a buyer of goods is subject to a security right that has become effective against third parties before the sale, unless the secured creditor authorized the sale, except that a buyer of inventory who buys encumbered assets in the ordinary course of business of the seller (and anyone whose rights to the encumbered assets derive from that buyer) takes free of a security right that is effective against third parties in those assets, even if such buyer has knowledge of the existence of the security right.

### **Reclamation claims**

46. If the law provides that suppliers of goods have the right to reclaim the goods within a specified time after the grantor becomes insolvent, the law should also provide that such specified time is short, and that the right to reclaim the goods is subordinate to security rights in such goods that are effective against third parties.

### **Lessees**

47. The law should address the priority of a security right in an asset that is effective against third parties as against the rights of a lessee of such asset.

### **Holders of promissory notes and negotiable documents**

48. The law should provide that the rights of a [person who by other law takes rights in a promissory note or negotiable document free of claims to it] [holder in due course of a promissory note or negotiable documents] takes such asset free of a security right that is effective against third parties.

### **Holders of rights in money**

49. The law should provide that the rights of a person who gives value for money and has possession of the money takes the money free of a security right in the money that is made effective against third parties only by registration.

### **Statutory (preferential) creditors**

50. The law should limit, both in number and amount, preferential claims that have priority over security rights that are effective against third parties, and to the extent preferential claims exist, they should be described in the law in a clear and specific way.

### **Holders of rights in assets for improving and storing assets**

51. If applicable law gives rights equivalent to security rights to a creditor who has added value to goods (e.g. by repairing them) or preserved the value of goods (e.g. by storing them), such rights should be limited to the goods whose value has been improved or preserved that are in the possession of such creditor, and should be effective against the holders of security rights in the goods that are effective against third parties only to the extent that the value added by the improvement or preservation directly benefits the holders of the pre-existing security rights. [*Note to the Working Group: The Working Group may wish to consider whether registration should be required.*]

### **Fixtures**

52. The law should set forth rules governing the relative priority of a holder of a security right in fixtures vis-à-vis persons who hold rights with respect to the related immovable property, such as a person (other than the grantor) who has an ownership interest in the immovable property, a purchaser of such property or a creditor whose security rights extend to the immovable property as a whole.

### **Insolvency representatives**

53. The law should provide that a secured creditor's priority should continue unimpaired in an insolvency proceeding of the grantor, subject to applicable provisions of the insolvency laws pertaining to preferential claims and avoidance actions.

### **Subordination agreements**

54. The law should recognize agreements that alter the priority of security rights, provided that they affect only the persons who actually consent to such alterations. Such agreements should be binding on such persons even in the case of the insolvency of the grantor of the security rights.



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### Recommendations of the draft Legislative Guide on Secured Transactions

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## V. Pre-default rights and obligations of the parties

### Purpose

55. The purpose of the provisions of the law on pre-default rights and obligations of the parties is to:

- (a) provide rules on additional terms for a security agreement with a view to rendering secured transactions more efficient and predictable;
- (b) reduce transaction costs by eliminating the need to negotiate and draft terms to be included in the security agreement where the rules provide an acceptable basis for agreement;
- (c) reduce potential disputes;
- (d) provide a drafting aid or check list of issues the parties may wish to address at the time of negotiation and conclusion of the security agreement; and
- (e) encourage party autonomy.

### Party autonomy

56. The law should allow the parties to waive or vary their rights and obligations unless such waiver or variation is against public policy and the protection of third parties.

### Suppletive rules

57. The law should include suppletive, non mandatory rules that would apply in the absence of contrary agreement of the parties. Such rules should, *inter alia*:

- (a) provide for the care of the encumbered assets by either the grantor or the secured creditor in possession of the encumbered assets;
- (b) preserve the security rights, including the right to proceeds or civil fruits derived from the encumbered asset;
- (c) provide for the right to use, commingle and dispose of the encumbered assets by the grantor in the ordinary course of business; and
- (d) secure the discharge of a secured obligation once it has been performed.

## **VI. Default and enforcement**

### **Purpose**

58. The purpose of the provisions of the law on default and enforcement is to:
- (a) provide clear and simple procedures for the enforcement of security rights upon debtor default in a predictable and efficient manner;
  - (b) maximize the realization value of the encumbered assets;
  - (c) provide transactional finality upon compliance with the enforcement procedure;
  - (d) define clearly the extent to which the secured creditor and the grantor may agree on the enforcement procedure;
  - (e) provide that the secured creditor in enforcing its rights must act in good faith, follow commercially reasonable standards and not violate public policy; and
  - (f) coordinate the enforcement rights and procedures of the secured transactions regime with the rights and procedures of other parties under other law, including insolvency law.

### **Notice of default and enforcement**

59. [The law should:
- (a) address whether notice of the default and enforcement should be given and to whom;
  - (b) state the minimum contents of the notice, the manner in which it is to be given, and its timing;
  - (c) state that the notice should also contain the secured creditor's calculation of the amount owed as a consequence of default; and
  - (d) detail the steps the debtor or the grantor may take to cure the default or recover the encumbered assets.]

### **Judicial and extra-judicial enforcement**

60. The law should provide options to the secured creditor following default to:
- (a) resort to court or other authorities to enforce its security right; or
  - (b) enforce its security right without resorting to official State institutions.
61. If the debtor, the grantor or other interested parties (e.g. a junior secured creditor, a guarantor, a co-owner of the encumbered assets, or a new secured creditor) object to actions of the secured creditor in enforcing its rights, the law should provide

them with an opportunity to have judicial or administrative review of acts of the secured creditor. Safeguards should be built into the process to discourage the debtor, the grantor or other interested third parties from making unfounded claims to delay the enforcement.

### **Party autonomy**

The law should permit parties to the security agreement to agree on the procedure of enforcement of security rights as between the parties, provided that the agreement conforms to the general rules of contract law and to recommendation 58(e). The person challenging the agreement on the procedure of enforcement has the burden of showing that the agreement does not meet the foregoing requirements.

### **Acceptance of the encumbered assets in satisfaction of the secured obligation**

62. The law should provide a procedure whereby the debtor, the grantor and the secured creditor can agree that the secured creditor will accept the encumbered assets in full or partial satisfaction of the secured obligation. The law should provide protection for other interested parties.

### **Cure of default**

63. Following default and until a disposition of the encumbered assets by the secured creditor, the debtor, the grantor or other interested parties should be permitted to satisfy the obligation secured by the encumbered assets by paying the outstanding secured obligation, including interest and the costs of enforcement up to the time of cure of default. The law should specify that the effect of such payment is to terminate the enforcement proceeding.

### **Disposition of the encumbered assets and distribution of proceeds**

64. The law should provide clear rules regarding notices, where required, and procedures relating to the disposition of encumbered assets by the secured creditor and distribution of proceeds.

65. General procedures for the disposition of the encumbered assets should include the method of advertising a proposed disposition, whether disposition would take place by public auction or sale, and whether it includes the right of the secured creditor to sell, lease, license or, in the case of intangibles and negotiable instruments, collect the encumbered assets.

### **Collection of intangibles and negotiable instruments**

66. The law should have special rules for the collection of intangibles and negotiable instruments, including the right to require the person obligated to make any payments owed to pay directly to the secured creditor.

### **Fixtures**

67. The law should have special rules on how a secured creditor is to proceed when a single transaction includes security rights in both movable and immovable assets.

### **Surplus and shortfall**



68. Any surplus remaining after the disposition of the encumbered assets and satisfaction of the secured obligation should be returned to the grantor, unless the secured creditor is required to distribute proceeds to other creditors. Any deficiency should be recoverable from the debtor as an unsecured claim.

### **Finality**

69. The law should specify that, upon disposition of the encumbered assets, the rights of the grantor and the secured creditor in the encumbered assets terminate and that the buyer or other person acquiring title to the encumbered assets receives title free of any interest of the grantor, the secured creditor, and any secured creditor with a lower priority status than the secured creditor.

### **Coordination with other law**

70. The law should be co-ordinated with general civil procedure law to provide a right for secured creditors to intervene in court proceedings initiated by other creditors of the grantor to protect security rights and to ensure the same priority status of claims as under the law.

### **Transfer of title and retention of title**

71. The law should provide that the transferee of title for security purposes should be entitled to enforce its rights in the same way as any other secured creditor. [The holder of a simple retention of title should be entitled to enforce its rights [as an owner of the encumbered assets] [in the same way as any other secured creditor.]]

## **VII. Insolvency**

### **Purpose**

72. The purpose of provisions of insolvency law on the enforcement of security rights in the grantor's insolvency is to:

- (a) balance the interests of persons, such as the grantor, secured creditors, unsecured creditors and preferential creditors;
- (b) recognize the pre-commencement effectiveness of security rights, subject to avoidance actions;
- (c) recognize the pre-commencement priority of security rights, subject to limited and clearly outlined exceptions; and
- (d) preserve the economic value of security rights.

**Rights of secured creditors in insolvency proceedings (see Insolvency Guide Recs. 38, 39, 43A, 110, 138)**

73. Subject to recommendations 75, 76, 85 and 88, the insolvency law should recognize the pre-commencement effectiveness and priority of security rights and protect the value of encumbered assets. [*Note to the Working Group: The Insolvency Guide does not contain a clear recommendation as to the time of valuation.*]

74. The insolvency law should specify that secured creditors are entitled to participate in insolvency proceedings.

**Encumbered assets part of the estate (see Insolvency Guide Recs. 24-26)**

75. The insolvency law should specify that the estate of the grantor includes:

- (a) assets subject to a security right;
- (b) third-party owned assets or the grantor's rights in such assets; [*Note to the Working Group: See Insolvency Guide Rec. 24 in A/CN.9/559/Add.1. Assets transferred for security purposes are part of the estate (see A/CN.9/543, para. 73). Whether, in the case of a retention of title, the assets or the grantor's rights in the assets are part of the estate is an open question for Working Group VI to decide depending on whether retention of title is treated as a security or as a title device.*]
- (c) assets recovered through avoidance or other actions;
- (d) proceeds of encumbered assets (including proceeds of proceeds) subject to the security right [*Note to the Working Group: While this recommendations is not inconsistent with the Insolvency Guide, it is not included in the Insolvency Guide (see Rec. 24). The Insolvency Guide does contain, however, a recommendation on the use of cash proceeds (see Rec. 43A in A/CN.9/559/Add.1)*]; and
- (e) assets acquired after the commencement of insolvency proceedings [, without being subject to the security right unless they constitute proceeds of assets encumbered before commencement of the insolvency proceedings]. [*Note to the Working Group: The bracketed text is not inconsistent with the Insolvency Guide. However, the Insolvency Guide does not contain such a specific recommendation.*]

**Application of the stay on encumbered assets (see Insolvency Guide Recs. 27-39)**

76. The insolvency law should specify that assets included in the estate are affected by the stay imposed in an insolvency proceeding.

77. The insolvency law should specify the requirements, duration and the effects of the stay, as well as the grounds for relief that may be granted to secured creditors. Such grounds may include that:

- (a) the encumbered asset is not necessary to a prospective reorganization or sale of the grantor's business

(b) the value of the encumbered asset is diminishing as a result of the commencement of the insolvency proceedings and the secured creditor is not protected against that diminution of value; and

(c) in reorganization, the plan is not approved within any applicable time limits.

78. The insolvency law should specify in particular that, upon application to the court, a secured creditor should be entitled to protection of the value of the assets in which it has an interest. The court may grant appropriate measures of protection that may include:

- (a) cash payments by the estate;
- (b) provision of additional security; or
- (c) such other means as the court determines.

**Use and disposal of encumbered assets (see Insolvency Guide Recs. 40-48)**

79. The insolvency law should permit:

(a) the use and disposal of assets of the estate (including assets subject to security rights) in the ordinary course of business, except cash proceeds; and

(b) the use and disposal of assets of the estate (including assets subject to security rights) outside the ordinary course of business provided that adequate notice is given to secured creditors, they have an opportunity to be heard by the court and the requirements of recommendation 82 are met.

80. The insolvency law should specify that assets subject to security rights may be further encumbered, subject to the requirements of recommendations 93 to 95.

81. The insolvency law should specify that the insolvency representative may use assets owned by a third party and in the possession of the grantor provided specified conditions are satisfied, including:

(a) the interests of the third party will be protected against diminution in the value of the assets; and

(b) the costs under the contract of [continued performance of the contract] [use of the assets] will be paid as an administrative expense. [*Note to the Working Group: This recommendation applies to transfer of title devices. Whether it applies to retention of title devices as well is an open question for WG VI.*]

82. The insolvency law should permit the insolvency representative to sell encumbered assets free and clear of any encumbrances, outside the ordinary course of business, provided that:

- (a) the insolvency representative gives notice of the proposed sale to secured creditors;
- (b) secured creditors are given the opportunity to object to the proposed sale;
- (c) relief from the stay has not been granted; and
- (d) the priority of secured creditors in the proceeds from the sale of the assets is preserved.

83. The insolvency law should permit the insolvency representative to use [and dispose of] cash proceeds if:

- (a) the secured creditor consents to such use [or disposal];
- (b) the secured creditor was given [notice of the proposed use [or disposal] and] an opportunity to be heard by the court; and
- (c) the interests of the secured creditor will be protected against diminution in the value of cash proceeds.

84. The insolvency law should permit the insolvency representative to determine the treatment of any assets, including encumbered assets, that are burdensome to the estate.

**[Treatment of contracts (see Insolvency Guide Recs. 55-72)]**

85. *Note to the Working Group: A recommendation with respect to the treatment of contracts may be needed if retention of title is to be treated as a partly performed contract rather than as a security agreement, the effectiveness of which has to be recognized subject to avoidance actions.]*

**Avoidance (see Insolvency Guide Recs. 73-83)**

86. The insolvency law should specify that, notwithstanding that a security right is effective and enforceable under other law, it may be subject to avoidance provisions of insolvency law on the same grounds as other transactions. [*Note to the Working Group: Avoidance under provisions other than insolvency law provisions is not addressed in the Insolvency Guide Recs.*]

87. The insolvency law should specify the types of transactions, including secured transactions, that may be avoided, establish a suspect period, provide for the conduct of avoidance proceedings and establish the conditions for avoidance and possible defences, as well as any liability of the counter-parties to avoided transactions.

**Priority of security rights (see Insolvency Guide Recs. 170-178)**

88. Subject to recommendation 89, the pre-commencement priority of secured claims should be respected. If priority is obtained by agreement, it should be respected to the extent parties have not agreed to a priority higher than that accorded to them under the applicable law (see recommendation 54).

89. Exceptions to the principle set forth in recommendation 88 should be limited, in number and value, and set out clearly in the insolvency law.

90. The insolvency law should provide that administrative costs and expenses should not be given priority over security rights.

91. The insolvency law should provide that, to the extent the value of the encumbered assets is insufficient to satisfy the secured obligation, the secured creditor may participate in the insolvency proceedings as an unsecured creditor. The insolvency law should also provide that, if there is a surplus, after all secured obligations have been satisfied, the surplus is to be returned to the estate. [*Note to the Working Group: Rec. 173 refers to “the value of the security” rather than to “the value of the encumbered assets” and to “secured claim” rather than to “secured obligations”. Rec. 175 of the Insolvency Guide focuses on the return of any surplus to the debtor (grantor for the purposes of the recommendations of this guide) after all claims (not just secured claims) have been paid.*]

**Post-commencement finance (see Insolvency Guide Recs. 49-54)**

92. The insolvency law should facilitate the insolvency representative obtaining post-commencement finance where the insolvency representative determines it to be necessary. The insolvency law may require authorization by the court or creditors (or the creditor committee).

93. The insolvency law should enable a security right to be granted in already encumbered assets for repayment of post-commencement finance.

94. The insolvency law should provide that a post-commencement security right over assets of the estate that have already been encumbered does not have priority over any existing security right, unless the insolvency representative obtains the agreement of the existing secured creditors or follows the procedure in recommendation 95.

95. The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security right having priority over a pre-existing security right provided that specified conditions are satisfied, including that:

- (a) the existing secured creditor was given an opportunity to be heard by the court;
- (b) the grantor can prove that it cannot obtain the finance in any other way; and
- (c) The interests of the existing secured creditor will be adequately protected.

**Participation of secured creditors in reorganization proceedings (see Insolvency Guide Recs. 123-145)**

96. If the insolvency law specifies that secured creditors can be bound to the terms of the plan, the insolvency law should also specify that those creditors [vote in [one or more] classes that are separate] shall be separately classified by category and shall vote by class separately] from unsecured creditors.

97. Where the insolvency law does not require approval by all classes [whose rights will be modified by the plan], the insolvency law should address the treatment of those classes that do not vote to support a plan that is otherwise approved by the requisite classes [consistent with recommendation 98]. [*Note to the Working Group: See Insolvency Guide Rec 130C and 134 in A/CN.9/559/Add.3.*]

98. Where the insolvency law requires court confirmation of an approved plan, the court should confirm the plan if the following conditions are satisfied:

- (a) [The requisite approvals have been obtained and] the approval process was properly conducted;
- (b) Creditors will receive [at least as much under the plan] [economic value worth at least as much, calculated as at the effective date of the plan,] as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (c) The plan does not contain provisions contrary to the law;
- (d) Administrative claims and expenses will be paid in full except to the extent that the holder of the claim or expense agrees to different treatment; and
- (e) [Except to the extent that [affected creditors or] [classes of creditors whose rights are modified by the plan] have agreed [otherwise,] the treatment of [creditor] claims in the plan conforms to the ranking of [creditor] claims under the insolvency law.] [The treatment accorded under the plan to the claims of a class of creditors that has voted against the plan, conforms to ranking of that class of claims under the insolvency law.]

*[Note to the Working Group: See Insolvency Guide Rec. 138 in A/CN.9/559/Add.3 (b). While all the insolvency recommendations will have to be adjusted to the final text of the Insolvency Guide Recs. This is particularly relevant for the recommendations on reorganization.]*

**Expedited reorganization proceedings (see Insolvency Guide Recs. 146-153)**

99. The insolvency law should provide for expedited reorganization proceedings. Once approved by a court, the reorganization plan in such proceedings should bind secured creditors in the same way as any other reorganization plan.

## **VIII. Conflict of laws**

### **Purpose**

100. The purpose of conflict of laws rules is to determine the law applicable to the creation, third party effectiveness, priority and enforcement of a security right.

### **Possessory security rights over tangible property**

101. The law should provide that the creation, third party effectiveness and priority of a possessory security right over tangible property are governed by the law of the State in which the encumbered asset is located.

### **Non-possessory security right over intangible property**

102. The law should provide that the creation, third party effectiveness and priority of a non-possessory security right over intangible property are governed by the law of the State in which the grantor is located.

### **Non-possessory security right over tangible property**

103. The law should provide that the creation, third party effectiveness and priority of a non-possessory security right over tangible property are governed by the law of the State in which the encumbered asset is located, except for tangible assets ordinarily used in more than one State, in which case such issues are governed by the law of the State in which the grantor is located.

### **Proceeds**

104. The law should provide that the conflict of laws rules applicable to proceeds are the same as the rules applicable to a security right in original encumbered assets of the same kind as the proceeds [except that the creation of a security right in proceeds should be governed by the law applicable to the creation of the right in the original encumbered asset from which the proceeds arose].

### **Changes in location**

105. The law should provide that the reference to the location of the assets or of the grantor in recommendations 101 to 103 refers, for creation issues, to that location at the time of the creation of the security right and, for third party effectiveness and priority issues, to that location at the time the issue arises.

106. The law should also provide that a security right made effective against third parties under the laws of the applicable State continues to be effective against third parties in another State after the location of the assets or of the grantor changes to the other State, if the requirements to make the security right effective against third parties in that other State are complied with within a specified period.

### **Goods in transit**

107. The law should provide that a security right over [goods] [tangible property] in transit may be validly created and made effective against third parties under the law

of the State of destination, provided that they are moved to that State within a certain specified time period.

#### **No party autonomy**

108. The law should provide that the parties to a security agreement cannot derogate from the rules set forth in recommendations 101 to 107.

#### **Enforcement matters**

109. The law should provide that:

##### **Alternative A**

Substantive matters affecting the enforcement of a security right are governed by the law of the State where enforcement takes place.

##### **Alternative B**

Substantive matters affecting the enforcement of a security right are governed by the law governing the priority of the right, subject however to the rules of the State where enforcement takes place that are mandatory irrespective of the law otherwise applicable.

##### **Alternative C**

Substantive matters affecting the enforcement of a security right are governed by the law governing the contractual relationship of the secured creditor and the grantor, subject however to the rules of the State where enforcement takes place that are mandatory irrespective of the law otherwise applicable.

#### **Procedural matters**

110. The law should provide that procedural matters relating to enforcement of security rights are governed by the law of the State where enforcement takes place.

#### **Impact of insolvency on conflict rules**

111. The law should provide that the occurrence of insolvency does not displace the conflict-of-laws rules applicable to the creation and third party effectiveness of a security right. With respect to priority, the law determined pursuant to the applicable conflict-of-laws rules should continue to govern, subject to the mandatory provisions of the insolvency regime of the enacting State.

#### **Enforcement in insolvency proceedings**

112. The law should provide that the insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) applies to all aspects of the enforcement of a security right in the insolvency proceedings (see Recs. 179-184 of the Insolvency Guide).



## **IX. Transition**

### **Purpose**

113. The purpose of transition provisions of the law is to provide a fair and efficient transition from the regime before the enactment of the law to the regime after the enactment of the law.

### **Effective date**

114. The law should specify a date, subsequent to its enactment, as of which it will enter into force (the “effective date”) in view of:

- (a) the impact of the effective date on credit decisions and in particular the maximisation of benefits to be derived from the law;
- (b) the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure;
- (c) the harmonization of the law with other legislation; and
- (d) the content of constitutional rules with respect to pre-effective date transactions; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

### **Transition period**

115. The law should provide a period of time after the effective date (the “transition period”), during which creditors with security rights effective against the grantor and third parties under the previous regime may take steps to assure that those rights are effective against the grantor and third parties under the law. If those steps are taken during the transition period, the law should provide that the effectiveness of the creditor’s rights against those parties is continuous.

### **Priority**

116. The law should provide clear rules for resolving:

- (a) which law applies to the priority between post-effective date security rights;
- (b) which law applies to the priority between pre-effective date security rights; and
- (c) which law applies to the priority between pre-effective date and post-effective date security rights.

117. The law should provide that priority between post-effective date security rights is governed by the law.

118. The law should provide generally that priority between pre-effective date security rights is governed by the former legal regime. The law should also provide, however, that application of those former rules will occur only if no event occurs after the effective date that would have changed the priority under the former regime. If such an event occurs, the law should determine priority.

119. With respect to priority between pre-effective date security rights and post-effective date security rights, the law should provide that it will apply as long as the holder of a pre-effective date right may, during the transition period, ensure priority under the law by taking whatever steps are necessary under the law. During the transition period, the priority of the pre-effective date right should continue as though the law had not become effective. If the appropriate steps are taken during the transition period, the holder of the pre-effective date right should have priority to the same extent as would have been the case had the law been effective at the time of the original transaction and those steps had been taken at that time.

120. When a dispute is in litigation (or a comparable dispute resolution system) at the effective date of the law, the law should specify that it does not apply to the rights and obligations of the parties.