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Draft Legislative Guide on Secured Transactions

Note by the Secretariat

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Introduction

A. Purpose of the Guide

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

2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (particularly small and medium-sized enterprises) and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making low-cost consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see the UNCITRAL *Legislative Guide on Insolvency Law*[1]).

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

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

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

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit. Secured credit is more readily available to businesses in States that have

[1] United Nations publication, Sales No. E.05.V.10.

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

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

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

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

10. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, buyers and other transferees, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that all creditors will accept such a balanced approach and will thereby be encouraged to extend credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately realize the economic value of the encumbered

assets in the event of non-payment by the debtor. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization or liquidation of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since these matters do not lend themselves to unification.

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

12. The Guide builds on the work of UNCITRAL and other organizations. Such work includes the European Bank for Reconstruction and Development Model Law on Secured Transactions, completed in 1994; the European Bank for Reconstruction and Development "Core principles for a secured transactions law", completed in 1997; the Organization for Harmonization of Business Law in Africa Uniform Act Organizing Securities, prepared in 1997; the study on secured transactions law reform in Asia,[2] prepared by the Asian Development Bank in 2000; the United Nations Convention on the Assignment of Receivables in International Trade (United Nations Assignment Convention),[3] adopted in 2001; the Convention on International Interests in Mobile Equipment, adopted in 2001, and the relevant protocols thereto; the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted in 2001; the Organization of American States Model Inter-American Law on Secured Transactions, prepared in 2002; the UNCITRAL *Legislative Guide on Insolvency Law*, completed in 2004; [the Unidroit Convention on Substantive Rules regarding Intermediated Securities; and […]].

B. Terminology and rules of interpretation

13. The Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a term appears to be the same as that found in a particular national law, the Guide does not intend to adopt the meaning of the term in that national law. Rather, the Guide provides definitions giving a specific meaning to each key term. Many definitions also have the effect of delimiting the

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[2] *Law and Policy Reform at the Asian Development Bank 2000*, vol. II (Asian Development Bank, 2000).

[3] General Assembly resolution 56/81, annex.

scope of the recommendations in the Guide that use those terms. Some recommendations use terms that are defined in those recommendations and some definitions are further elaborated in recommendations that use a defined term. Thus, the scope and content of each recommendation depend on the meaning of the defined terms used.

14. The Guide's approach of using defined terms is taken to facilitate precise communication, independent of any particular national legal system, and to enable readers of the Guide to understand its recommendations uniformly, providing them with a common vocabulary and conceptual framework. The definitions should be read with care and should be referred to whenever the defined terms are encountered.

15. While the terms are not of themselves an imperative element of the Guide's recommendations, legislation based on the Guide will typically include specific definitions for the terms that are used. Even if the terms used in the legislation differ from those used in the Guide, the definitions provided in the terminology might be used. This would avoid unintended substantive change and would make it most likely that the terms used will be understood uniformly by judges, commercial parties and their counsel, both inside and outside of the enacting State, from the outset, to maximize uniform interpretation immediately upon the effective date of the new legislation, thereby avoiding periods of doubt pending judicial interpretation. Use of the terms and, more importantly, the definitions provided in the Guide will also encourage harmonization of the law governing security rights.

16. The word "or" is not intended to be exclusive; use of the singular also includes the plural and vice versa; "include" and "including" are not intended to indicate an exhaustive list; "may" indicates permission and "should" indicates instruction; and "such as" and "for example" are to be interpreted in the same manner as "include" or "including". "Creditors" should be interpreted as including both the creditors in the forum State and foreign creditors, unless otherwise specified. References to "person" should be interpreted as including both natural and legal persons, unless otherwise specified.

17. Some States may choose to implement the recommendations of the Guide by enacting a single comprehensive statute (a method more likely to produce coherence and avoid errors of omission or misunderstanding), while other States may seek to modify their existing body of law by insertions of specific rules in various places. The Guide refers to the entire body of recommended rules, whichever method is chosen for implementation, as "the law" or "this law".

18. The Guide also uses the term "law" in various other contexts. Except when otherwise expressly provided, throughout the Guide: (a) all references to law refer to both statutory and non-statutory law; (b) all references to law refer to internal law, excluding conflict-of-laws rules (so as to avoid *renvoi*); (c) all references to "law other than the secured transactions law" refer to the entire body of a State's law (whether substantive or procedural) other than that embodying the law governing secured transactions over movable property (whether pre-existing or newly enacted or modified pursuant to the recommendations of the Guide); (d) all references to "the law governing … (e.g., negotiable instruments)" refer not only to a special statute or body of law denominated as "negotiable instruments law" but include also all contract and other general law that might be applicable to

transactions or situations involving a negotiable instrument; and (e) all references to "insolvency law" are similarly all-encompassing, but refer only to law that might be applicable after the commencement of an insolvency proceeding.

19. The following paragraphs identify the principal terms used and the core meaning given to them in the Guide. The meaning of these terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms (as is the case, for example, with the insolvency chapter). The definitions should be read together with the relevant recommendations. The principal terms are defined as follows:

(a) "Security right" means a consensual property right in movable property and attachments that secure payment or other performance of one or more obligations, regardless of whether the parties have designated it as a security right. It includes acquisition security rights and non-acquisition security rights. With respect to receivables, security right also means the right acquired by an outright transfer of a receivable, as well as a transfer by way of security. In order to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided, references to a "security right" in the Guide also refer to the "right of an assignee";

(b) "Acquisition security right" means [, in the context of a unitary approach,] a security right in an asset that secures the obligation to pay any unpaid portion of the purchase price of the asset or an obligation incurred to enable the grantor to acquire the asset. Acquisition security rights include not only rights that are denominated as security rights but also rights retained or derived under retention-of-title sales, hire-purchase transactions, financial leases and purchase-money lending transactions. "Grantor" of an acquisition security right includes a buyer, financial lessee or grantor in a purchase-money lending transaction. "Acquisition financier" means the secured creditor with an acquisition security right and includes a retention-of-title seller, financial lessor or purchase-money lender;

[*Note to the Working Group: See note after definition (b) in document A/CN.9/WG.VI/WP.29.*]

(c) "Secured obligation" means the obligation secured by a security right;

(d) "Secured creditor" means a creditor that has a security right. In order to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided, references to the "secured creditor" in the Guide also refer to the "assignee";

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

(f) "Grantor" means a person that creates a security right in one or more of its assets in favour of a secured creditor to secure either its own obligation or that of another person (see debtor of the receivable). In order to ensure that the general recommendations apply to security rights in receivables and to outright transfers of receivables, unless otherwise provided, references to the "grantor" in the Guide also refer to the "assignor";

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

(h) “Encumbered asset” means tangible or intangible movable property that is subject to a security right;

(i) “Tangible property” means all forms of corporeal movable property. Among the categories of tangible property are inventory, equipment, attachments, negotiable instruments, negotiable documents and money;

(j) “Inventory” means a stock of tangible property held for sale or lease in the ordinary course of the grantor’s business and also raw and semi-processed materials (work-in-process);

(k) “Equipment” means tangible property used by a person in the operation of its business;

(l) “Attachments to immovable property” means tangible property that is so physically attached to immovable property that, despite the fact that it has not lost its separate identity, is treated as immovable property under the law of the State where the immovable property is located;

(m) “Attachments to movable property” means tangible property that is so physically attached to other tangible property that, despite the fact that it has not lost its separate identity, it is treated as part of that movable property under law other than this law;

(n) “Mass or product” means tangible property other than money that is so physically associated or united with other tangible property that it has lost its separate identity;

(o) “Intangible property” means all forms of movable property other than tangible property and includes incorporeal rights, receivables and rights to the performance of obligations other than receivables;

(p) “Receivable” means a right to payment of a monetary obligation and a contractual right to performance of a non-monetary obligation excluding rights to payment evidenced by a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account;

[*Note to the Working Group: See note after definition (p) in document A/CN.9/WG.VI/WP.29.*]

(q) “Assignment” means the creation of a security right in a receivable and includes an outright transfer of a receivable. The creation of a security right in a receivable includes an outright transfer by way of security;

(r) “Assignor” means the person that makes an assignment of a receivable;

(s) “Assignee” means the person to which an assignment of a receivable is made;

(t) “Subsequent assignment” means an assignment by the initial or any other assignee. In the case of a subsequent assignment, the person that makes that assignment is the assignor and the person to which that assignment is made is the assignee;

(u) "Debtor of the receivable" means a person liable for payment of a receivable. "Debtor of the receivable" includes a guarantor or other person secondarily liable on the receivable.

A guarantor is not only a debtor of the receivable, the payment of which it has guaranteed, but also a debtor of the receivable that is constituted by the guarantee, as a guarantee is itself a receivable (i.e. there are two receivables);

(v) "Notice" means a communication in writing, except where otherwise provided in the Guide;

(w) "Notification of the assignment" means a communication in writing that reasonably identifies the assigned receivable and the assignee. The writing requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference (see article 6 of the UNCITRAL Model Law on Electronic Commerce[4] and article 9, paragraph 2, of the United Nations Convention on the Use of Electronic Communications in International Contracts[5]);

[*Note to the Working Group: See note after definition (v) in document A/CN.9/WG.VI/WP.29.*]

(x) "Original contract" in the context of an assignment means the contract between the assignor and the debtor of the receivable from which the receivable arises. With respect to non-contractual receivables, "original contract" means the non-contractual source of the receivable;

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

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

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

(bb) "Proceeds under an independent undertaking" means the right to receive a payment due, a draft accepted or deferred payment incurred or another item of value, in each case to be delivered by the guarantor/issuer honouring or by a nominated person giving value for a draw under an independent undertaking. The term does not include:

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[4] United Nations publication, Sales No. E.99.V.4.

[5] General Assembly resolution 60/21, annex.

(i) The right to draw (i.e. to request payment) under an independent undertaking; or

(ii) What is received upon honour of an independent undertaking or upon disposition of proceeds under an independent undertaking (i.e. the proceeds derived from collection or disposition of the proceeds under an independent undertaking).

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

The term "proceeds under an independent undertaking" refers to a right to receive even though the term "proceeds" as used in independent undertaking law and practice may refer either to the right to receive or to whatever is received under the independent undertaking, and even though the term "proceeds" as used elsewhere in the Guide refers to whatever is received. A security right in proceeds under an independent undertaking (as an original encumbered asset) is different from a security right in "proceeds" (a key concept of the Guide) of assets covered in the Guide;

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

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

In line with article 6 (e) of the United Nations Guarantee and Stand-by Convention, a confirmation provides the beneficiary with the option of demanding payment from the confirmer in conformity with the terms and conditions of the confirmed independent undertaking instead of from the guarantor/issuer;

(ee) "Nominated person" means a bank or other person that is identified in an independent undertaking by name or type (e.g. "any bank in country X") as being nominated to give value under an independent undertaking and that acts pursuant to that nomination;

(ff) A secured creditor has "control" with respect to proceeds under an independent undertaking:

(i) Automatically upon the creation of the security right if the guarantor/issuer, confirmer or nominated person is the secured creditor; or

(ii) If the guarantor/issuer, confirmer or nominated person has made an acknowledgment in favour of the secured creditor;

(gg) "Acknowledgment" with respect to proceeds under an independent undertaking means that the guarantor/issuer, confirmer or nominated person that will pay or otherwise give value upon a draw under an independent undertaking has, unilaterally or by agreement:

(i) Acknowledged or consented to (however acknowledgement or consent is evidenced) the creation of a security right (whether denominated as an assignment or otherwise) in favour of the secured creditor in the proceeds from an independent undertaking; or

(ii) Has obligated itself to pay or give value to the secured creditor upon a draw under an independent undertaking;

(hh) "Bank account" means an account that is maintained by a bank into which funds may be deposited or credited. The term includes a checking or other current account, as well as a savings or time-deposit account. The term does not include a claim against the bank evidenced by a negotiable instrument.

The right to payment of funds credited to a bank account covers a right to the payment of funds transferred into an internal account of the bank and not applied to any obligations owing to the bank. Funds transferred to the bank by way of anticipated reimbursement of a future payment obligation that the bank has accepted in the ordinary course of its banking business is also covered to the extent that the person that gave the bank instructions has a claim to those funds if the bank does not make the future payment;

(i) A secured creditor has "control" with respect to a right to payment of funds credited to a bank account:

(i) Automatically upon the creation of a security right if the depositary bank is the secured creditor;

(ii) If the depositary bank has concluded a control agreement evidenced by an authenticated record with the grantor and the secured creditor, according to which the depositary bank has agreed to follow instructions from the secured creditor with respect to the payment of funds credited to the bank account without further consent of the grantor; or

(iii) If the secured creditor is the account holder.

There is no obligation on a depositary bank to enter into a control agreement. In addition, a secured creditor's rights will be subject to the rights and obligations of the depositary bank under law and practice governing bank accounts. Moreover, a control agreement requires the consent of the grantor (as well as of the depositary bank) and the grantor retains the right to deal with the funds in the bank account until the secured creditor instructs the depositary bank otherwise (although in some control agreements, the funds would be blocked from the time of the conclusion of the control agreement). This covers situations where: (a) an existing account is transferred to the secured creditor, (b) the secured creditor agrees with the grantor that funds should be deposited to an account to be opened later, and (c) the secured creditor is the only account holder (i.e. not merely a joint account holder);

(jj) "Intellectual property right" includes patents, trademarks, service marks, trade secrets, copyright and related rights and designs. It also includes rights of a licensee under licences of such rights;

(kk) “Proceeds” means whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or licence of an encumbered asset, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects, damage to or loss of an encumbered asset;

(ll) “Priority” means the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant;

(mm) “Competing claimant” means:

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

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

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

(iv) The insolvency representative in the insolvency of the grantor;[6] or

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

(nn) “Possessory security right” means a security right in tangible property that is in the possession of the secured creditor;

(oo) “Non-possessory security right” means a security right in tangible property that is not in the possession of the secured creditor;

[*Note to the Working Group: See note after definition (nn) in document A/CN.9/WG.VI/WP.29.*]

(pp) “Possession”, except as the term is used in recommendations 27 and 48 to 50 with respect to the issuer of a negotiable document, means the actual possession of tangible property by a person or an agent or employee of that person, or by an independent person that acknowledges that it holds for that person. It does not include constructive, fictive, deemed or symbolic possession;

(qq) “Issuer” of a negotiable document means the person who is obligated to deliver the tangible property covered by the document under the law governing negotiable documents.

In the case of a so-called multimodal bill of lading (if it qualifies as a negotiable document under the applicable law), the “issuer” may be a person who subcontracts various portions of the transport of the goods to other persons but still takes responsibility for their transport and for any damage that might occur during carriage;

(rr) “Insolvency court” means a judicial or other authority competent to control or supervise an insolvency proceeding;

[6] In the chapter on insolvency, reference is made to “the insolvency of the debtor” for reasons of consistency with the terminology used in the UNCITRAL *Legislative Guide on Insolvency Law* (see footnote 55 of document A/CN.9/WG.VI/WP.29, chapter XI on insolvency).

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

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

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

(vv) "Buyer in the ordinary course of business" means a person that buys inventory in the ordinary course of the seller's business from a seller in the business of selling tangible property of that kind and without knowledge that the sale violates the rights of the secured creditor under the security agreement [or other rights of another person in the property];

(ww) "Lessee in the ordinary course of business" means a person that leases inventory in the lessor's ordinary course from a lessor in the business of leasing tangible property of that kind and without knowledge that the lease violates the rights of the secured creditor under the security agreement [or other rights of another person in the property];

(xx) "Licensee in the ordinary course of business" means a person that licenses intangible property in the licensor's ordinary course from a licensor in the business of licensing property of that kind and without knowledge that the licence violates the rights of the secured creditor under the security agreement [or other rights of another person in the property].

The terms "buyer in the ordinary course of business", "lessee in the ordinary course of business" and "licensee in the ordinary course of business" are referred to in recommendation 83 dealing with the rights of buyers, lessees and licensees of encumbered assets (see A/CN.9/WG.VI/WP.29, chap. VII). It is possible for a buyer, lessee or licensee to know of the existence of a security right but not know whether the transfer violates the terms of the security agreement. In the rare cases in which the buyer of inventory has knowledge not only of the security right but also that the sale violates the terms of the security agreement, the buyer will not qualify as a buyer in the ordinary course of business and, therefore, not take free under recommendation 83, subparagraph (a). The test in recommendation 83 is the same as in recommendations 94 (priority of a security right in a right to payment of funds credited to a bank account) and 95 (priority of a security right in money);

(yy) "Consumer goods" means goods that the grantor uses or intends to use for personal, family or household purposes.

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

20. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime. These objectives are designed to provide a broad policy framework for the establishment and development of such a regime.

A. Promoting secured credit

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

B. Allowing utilization of the full value inherent in a broad range of assets to support credit in the widest possible array of credit transactions

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

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

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

D. Providing for equal treatment of diverse sources of credit

24. Because healthy competition among all potential creditors is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to various creditors, including banks and other financial institutions, as well as domestic and non-domestic creditors.

E. Validating non-possessory security rights

25. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights

in a broad range of assets coupled with a mechanism in the form of a public registry system for publicizing the existence of such security rights.

F. Encouraging responsible behaviour on the part of all parties by enhancing predictability and transparency

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

G. Establishing clear and predictable priority rules

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

H. Facilitating enforcement of creditors' rights in a predictable and efficient manner

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

I. Balancing the interests of affected persons

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

J. Recognition of party autonomy

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

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

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

Recommendation 1 [*Note to the Working Group: The Working Group may wish to note that the recommendations will be set out immediately after the relevant commentary. Accordingly, recommendation 1 will be inserted here in the final version of the Guide.*]

II. Scope of the Legislative Guide

32. The regime envisioned by the Guide is intended to be a single, comprehensive regime for secured transactions, affecting the widest possible array of assets, parties, secured obligations, security rights and financing practices.

A. Assets covered

33. The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of assets are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, both tangible and intangible, with the exception of assets specifically excluded.

34. The Guide covers all types of movable property and attachment, tangible or intangible, present or future, including inventory, equipment and other goods, contractual and non-contractual receivables, contractual non-monetary obligations, negotiable instruments, negotiable documents, rights to payment of funds credited

to a bank account, proceeds under an independent undertaking, and intellectual property rights. With respect to receivables, the general recommendations, as supplemented by the recommendations on receivables apply both to: (a) contractual and non-contractual receivables, except that recommendations 22 (effectiveness of a bulk assignment and an assignment of future, parts of, and undivided interests in receivables) and 109 (representations of the assignor) do not apply to non-contractual receivables; and (b) contractual non-monetary obligations. Law other than the law recommended in the Guide applies to the rights of obligors of contractual non-monetary obligations.

35. Some assets, such as aircraft, railway rolling stock, space objects, ships and intellectual property rights are in whole or in part subject to special laws. Security rights in such assets are covered by the Guide but, in the case of any inconsistency between such a special law and secured transactions law, the special law (e.g. the special registration system) prevails to the extent of the inconsistency. Where a direct inconsistency exists, the law should expressly confirm that the special laws and international obligations govern those assets to the extent of that inconsistency. The reference to aircraft, railway rolling stock, space objects, ships and intellectual property rights should be understood pursuant to the meaning of those terms in national law or international conventions dealing with them.

36. In developing its secured transactions law, a State should take account of the increasing importance and economic value of intellectual property assets to companies seeking to obtain low-cost secured credit.

37. A State enacting secured transactions legislation in accordance with the Guide should consider whether it might be appropriate to adjust certain of those recommendations as they apply to intellectual property rights. In this regard, a State should examine its existing intellectual property laws and the State’s obligations under international conventions and, if the recommendations of the Guide are inconsistent with any such laws or conventions, the State’s secured transactions law should confirm that those existing laws and conventions govern such issues to the extent of the inconsistency. In considering whether any adjustments of the recommendations as they apply to security rights in intellectual property are appropriate, a State should analyse each circumstance on an issue-by-issue basis and should have proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with international conventions and national laws.

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

B. Assets excluded

39. Immovable property, securities and employment payments are types of asset that are subject to an outright exclusion from the Guide.

40. Immovable property (with the exception of attachments, which are covered by the Guide and can be subjected to security rights) is excluded as it raises different issues and is subject to a special title registration system indexed by asset and not by grantor.

41. In addition, the Guide does not cover security rights in securities because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. The substantive law issues relating to security and other rights in securities held with an intermediary are dealt with in a draft convention being prepared by the International Institute for the Unification of Private Law (Unidroit).

42. The private international law issues with respect to that subject matter are not addressed in the Guide since they are dealt with in the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities (The Hague, December 2002).

43. The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by Unidroit and the Hague Conference, as well as relevant texts prepared by UNCITRAL, such as the United Nations Convention on the Assignment of Receivables in International Trade (New York, December 2001; hereinafter referred to as "the United Nations Assignment Convention") and the UNCITRAL *Legislative Guide on Insolvency Law*.

44. Although immovable property and securities are excluded from the scope of the Guide as original encumbered assets, they may be affected by the Guide's recommendations. If a security right in a mortgage or securities secures a receivable, negotiable instrument or other obligation and the receivable, negotiable instrument or other obligation is assigned, the security right in the securities or the mortgage follows. This rule does not affect any third-party rights, priority and enforcement requirements existing under immovable property law or securities law. For example, the priority of a security right in intermediated securities will be determined under securities law (see A/CN.9/WG.VI/WP.29, chap. IV, recommendation 24, and chap. V, recommendation 45).

[*Note to the Working Group: The Working Group may wish to note that whether directly held securities and whether immovable property or securities as proceeds are to be covered remain open questions (see A/CN.9/WG.VI/WP.29, chap. II, note to recommendation 5).*]

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

C. Parties covered

46. Any person, physical or legal, may be a debtor, grantor or secured creditor under the Guide. The Guide may also apply to consumers as there is no reason why consumers should be deprived of the benefits of the regime envisaged in the Guide. However, to the extent a rule of the regime envisaged in the Guide conflicts with consumer-protection law, consumer-protection law would prevail. States that do not have a body of law for the protection of consumers may wish to consider whether the enactment of a law based on the recommendations of the Guide would affect the rights of consumers and would thus require the introduction of consumer-protection legislation.

D. Obligations covered

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

E. Rights covered

48. The Guide deals with consensual security rights. However, it contains references to non-consensual rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.29, chap. VII, recommendations 85-88).

49. To ensure a comprehensive coverage of all devices that serve security functions, the Guide also deals with rights that, while they are not denominated as security rights, nevertheless serve security purposes (see A/CN.9/WG.VI/WP.29, chap. XII, recommendations 182-194).

50. The Guide also deals with rights that are not security rights (i.e. outright sales of receivables) where it is necessary to avoid characterization issues and to ensure that the registry system and the priority rules of the Guide apply to all such rights.

F. Examples of financing practices covered in the Legislative Guide

51. Set forth below are short examples of the types of secured credit transactions that the Guide is designed to encourage and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use and an effective secured transactions regime must be sufficiently flexible to accommodate

many existing methods of financing, as well as methods that may evolve in the future.

1. Inventory and equipment acquisition financing

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

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

54. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within 30 days of Vendor A's invoice to ABC, and ABC grants to Vendor A a security right in the paint to secure the purchase price. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the drill presses within 10 days after they are delivered to ABC's plant. ABC obtains a loan from Lender A to finance the purchase of the drill presses from Vendor B, secured by a security right in the drill presses. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the bank account as additional security for the repayment of the loan.

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

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

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

2. Inventory and receivable revolving loan financing

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

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

60. Here is an illustration of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving loan facility to ABC to finance this process. Under the loan facility, ABC may obtain loans from time to time in an aggregate amount of up to 50 per cent of the value of its inventory that Lender B deems to be acceptable for borrowing (based upon the type and quality of the inventory, as well as other criteria) and of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the account debtors). ABC is expected to repay these loans from time to time as it receives payments from its customers. The loan facility is secured by all of ABC's existing and future inventory and receivables. In this type of financing, it is also common for the lender to obtain a security right in the bank account into which customer payments (i.e. the proceeds of inventory and receivables) are deposited.

3. Factoring

61. Factoring is a highly effective form of receivables financing that can trace its roots back thousands of years. In general, factoring involves the outright purchase of receivables from the grantor, as seller (assignor) to the factor (assignee). Such an outright transfer of receivables falls within the definition of a security right for purposes of the Guide (see definition (a) "security right" above).

62. There are a number of different types of factoring arrangement. The factor may pay a portion of the purchase price for the receivables at the time of the purchase ("discount factoring"), only when the receivables are collected ("collection factoring"), or on the average maturity date of all of the factored receivables ("maturity factoring"). The assignment of the receivables can be with or without recourse to the assignor in the event of non-payment of the receivables by the debtors of the receivables (i.e. the customers of the assignor). Finally, the debtors of the receivables may be notified that their receivables have been factored ("notification factoring"), or they may not be so notified ("non-notification factoring"). When notice is given to the customers, it is often accomplished by requiring the assignor to place a legend on the invoices that the assignor sends to its customers. The factor may also perform various services for the assignor in respect of the receivables, ranging from approving and evaluating the creditworthiness of the debtors of the receivables, performing bookkeeping duties and engaging in collection efforts with respect to receivables that are not paid when due. These services can provide a useful benefit to companies that do not have their own credit and collection departments.

63. Here is an illustration of a typical factoring arrangement: ABC enters into a discount factoring arrangement with Factor, pursuant to which Factor agrees to purchase receivables that Factor deems to be creditworthy. Factor advances to ABC an amount equal to 90 per cent of the face value of such receivables, holding the remaining 10 per cent as a reserve to cover potential customer claims and allowances that would reduce the value of the receivables. The factoring arrangement is with notification to ABC's customers.

4. Securitization

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

65. Securitization is intended to lower the cost of financing because the SPV is structured in a way to make the risk of its insolvency "remote" (e.g. theoretically not possible) by restricting the amount of debt that the SPV can incur. That significantly reduces one risk that the lender has to take into account when deciding what interest rate to charge for the loan. In addition, because the source of credit is the capital markets rather than the banking system, securitization can generate greater amounts of credit than bank loans and at lower costs than the normal bank loan costs.

66. Here is an illustration of a securitization transaction: An SPV is created by a subsidiary of an automobile manufacturer to purchase automobile leases from automobile dealers throughout a geographically defined market. The automobile

leases are purchased from the dealers for a discount from the projected value of the payment streams expected to be generated by such leases. The SPV then issues debt securities, under applicable securities laws, to investors in the capital market secured by such income stream. As payments are made under the leases, the SPV will use such proceeds to make payments on the debt securities.

5. Term-loan financing

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

68. As is the case with many other types of financing, a business that does not have strong, well-established credit ratings will have difficulty obtaining term-loan financing, unless the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, immovable property is the only type of asset that typically is accepted by lenders to secure term-loan financing and, as a result, in such States term-loan financing is often not available for other important asset types, such as equipment or the enterprise value of an entire business. This is most likely the case in States that do not have a modern secured transactions regime. However, many businesses, in particular newly established businesses, do not own any immovable property and, therefore, may not have access to term-loan financing. In other States, term loans secured by movable property, such as equipment, intellectual property and the enterprise value of the business, are common.

69. Here is an illustration of this type of financing: ABC desires to expand its operations and purchase a business. ABC obtains a loan (predicated on the value of, and secured by, substantially all of the assets of the business being acquired) from Lender C to finance such acquisition. The loan is repayable in equal monthly instalments over a period of 10 years and is secured by existing and future assets of ABC and the entity being acquired.

6. Transfer of title for security purposes

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

7. Sale and leaseback transactions

71. A sale and leaseback transaction provides a method by which a company can obtain credit based upon its existing tangible property (usually equipment) while still retaining possession and the right to use the tangible property in the operation of its business. In a sale and leaseback transaction, the company will sell its assets

to another person for a specific sum (which the company may then use as working capital, to make capital expenditures or for other purposes). Simultaneously with the sale, the company will lease the equipment back from that other person for a lease term and at a rental rate specified in the lease agreement. Often, the lease is a "financial lease" as opposed to an "operating lease" (see para. 27 above for a definition of both terms).

Recommendations 2-7 [*Note to the Working Group: The Working Group may wish to note that recommendations 2-7 will be inserted here in the final version of the Guide.*]