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**Draft legislative guide on secured transactions****Report of the Secretary-General****Contents**

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## **Draft legislative guide on secured transactions**

*[Prefatory remarks to be prepared at a later stage]*

### **I. Introduction**

#### **A. Organization and scope**

1. The purpose of this Guide is to assist States in the development of modern secured transactions laws, with the goal of promoting the availability of low-cost secured credit for commercial enterprises doing business in such States. 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 co-ordinate their laws with those of other States (including through the mutual recognition of security rights validly created in other jurisdictions). The Guide is based on the premise that a sound secured transactions regime can have many benefits for States that adopt it, including attracting credit from domestic as well as from foreign lenders, promoting the development and growth of domestic businesses, and generally promoting trade. Such a regime also can result in benefits for consumers by lowering the cost of goods and services and promoting the availability of low-cost consumer credit.

2. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. 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.

3. 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 (World Bank), the International Monetary Fund (IMF), the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD) that one of the most effective means of providing working capital to commercial enterprises is through secured credit.<sup>1</sup>

4. The key to the effectiveness of secured credit is that it allows borrowers to use the value inherent in their assets as a means of reducing credit risk for the creditor. Risk is mitigated because loans secured by the property of a borrower give lenders recourse to the property in the event of non-payment. Studies have shown that as the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls. Studies have also shown that in States where lenders perceive the risks associated with transactions to be high, the cost of credit increases as lenders require increased compensation to evaluate and assume the increased risk.

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<sup>1</sup> See, for example: Asian Development Bank, "Secured Transactions Law Reform in Asia: Unleashing the Potential of Collateral", December 2000.

In some countries, the absence of an effective secured transactions regime has resulted in the virtual elimination of credit for consumers or commercial enterprises.

5. A legal system that supports secured credit transactions is critical to reducing such perceived risks and promoting the availability of secured credit. Studies have shown that secured credit is more readily available to businesses in States that have efficient and effective laws that allow for consistent, predictable outcomes for creditors in the event of non-performance by borrowers.

6. Creating a legal system that promotes secured credit not only aids in the cultivation and growth of individual businesses, but also in the economic prosperity of States as a whole. An inadequate legal system for secured transactions can result in significant losses in gross domestic product. Thus, countries that restrict the breadth or effectiveness of their secured transactions laws may deny themselves a valuable potential economic benefit.

7. Various concerns with respect to secured credit have been voiced. For example, providing a creditor with a priority claim to a grantor's assets may limit the ability of the grantor to obtain financing from other sources. Additionally, a secured creditor can wield significant influence over a grantor's business, as the creditor may seize, or threaten seizure of, the encumbered asset upon default. To address these issues, the Guide suggests solutions that establish a balance between the interests of debtors, creditors, affected third parties and the State. This requires, among other things, a coordination between the secured transactions and insolvency law regimes.

8. The Guide builds on the work of UNCITRAL and other organizations. Such work includes: the United Nations Convention on the Assignment of Receivables in International Trade, adopted in December 2001; the Convention on International Interests in Mobile Equipment, approved in November 2001; the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD General principles of a modern secured transactions law, completed in 1997; the study on Secured Transactions Law Reform in Asia, prepared by the Asian Development Bank in 2000; the OAS Model Inter-American Law on Secured Transactions, prepared in 2002; the Hague Conference Convention on the law applicable to dispositions of rights in securities, prepared in [...] and the Unidroit [Convention] [Model Law] on security interests in securities, prepared in [...].

## **B. Terminology**

9. This Guide has adopted terminology to express the concepts that underlie a model secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given the term may differ. The following paragraphs identify the principal terms used and the core meaning given to them in this Guide. The meaning of these terms is further refined when the terms are used in subsequent chapters.

<b>Security right</b>	A “security right” is a consensual right in movable property that secures payment or other performance of one or more obligations.
<b>Secured obligation</b>	The obligation secured by a security right is a “secured obligation”.
<b>Secured creditor</b>	A “secured creditor” is a creditor that has a security right. The creditor may be either a physical or legal person.
<b>Debtor</b>	A “debtor” is a physical or legal person that owes performance of the secured obligation. The debtor may or may not be the person who transfers the security right to a secured creditor (see grantor).
<b>Grantor</b>	A “grantor” is a physical or legal person who creates a security right in favour of a secured creditor. The grantor may or may not be the debtor who owes performance of the secured obligation (see debtor).
<b>Security agreement</b>	A “security agreement” is an agreement between a grantor and a creditor which creates a security right that secures one or more of the debtor’s obligations.
<b>Encumbered assets</b>	The movable property subject to a security right is an “encumbered asset”. This Guide focuses on security rights in tangible and intangible movable property, including rights to the payment of a monetary sum. Unless otherwise indicated, the Guide does not deal with immovable property. For some purposes this Guide distinguishes between different types of encumbered assets. In general, encumbered assets are divided into tangible and intangible movable property (goods and intangibles, respectively). Each of these two general classes comprises several sub-types.
<b>Goods</b>	The term “goods” includes all forms of tangible movable property. Among the sub-types of goods are inventory, equipment and fixtures.
<b>Inventory</b>	“Inventory” includes not only a stock of goods held for sale or lease in the usual course of business but also raw materials, semi-processed goods, and materials used or consumed by a person in the operation of its business.
<b>Equipment</b>	“Equipment” means goods other than inventory used by a person in the operation of its business.
<b>Fixtures</b>	The term “fixtures” means goods that have become or are destined to become so attached to immovable property that an interest in them arises under the law governing immovable property.
<b>Intangibles</b>	The term “intangibles” covers all movable property other than goods [perhaps, with the exception of rights embodied in a negotiable instrument]. Among the sub-types of intangibles are claims, receivables and investment property.
<b>Claims</b>	The term “claims” includes both a right to the payment of a monetary sum and a right to the performance of a non-monetary obligation.

<b>Receivables</b>	The term “receivables” means a right to the payment of a monetary sum.
<b>Investment property</b>	“Investment property” includes (a) shares and other interests in enterprises; (b) bonds, debentures and other debt obligations of enterprises; and (c) commodity contracts. Investment property may be in tangible or intangible form. It may be held directly by a debtor or in an account with an intermediary.
<b>Enterprise</b>	An “enterprise” is a business establishment recognized by applicable law as having a separate legal existence. A security right in an enterprise covers all or designated types of movable property owned by the enterprise.
<b>Proceeds</b>	“Proceeds” includes the fruits of encumbered assets and whatever is received on the disposition of encumbered assets. Dividends paid by a company whose shares are held by a secured creditor as a pledge are proceeds, as are the monetary sums received when the shares are sold following the debtor’s default.
<b>Priority</b>	The “priority” of a secured creditor refers to the extent to which the secured creditor may derive the economic benefit of its security right in preference to other parties raising a claim in the same property. Rules of priority rank security and other property rights in encumbered assets in the order in which they are to be satisfied.

## II. Key objectives of an efficient secured transactions regime

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

### A. Utilize full value of assets to obtain credit

11. A key to a successful legal regime governing secured transactions is to enable grantors to utilize the value inherent in their property to the maximum extent possible to obtain credit. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (i) permitting a broad range of assets to serve as encumbered assets (such as receivables, inventory, equipment, intellectual property and other intangibles, and investment property); (ii) permitting a broad range of obligations (including future advances under a loan facility and other future obligations) to be secured; and (iii) extending the benefits of the regime to a broad array of debtors, creditors and credit transactions.

### B. Obtain security in a simple and efficient manner

12. The ability to encumber assets will only reduce the cost of credit 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. Such methods include: eliminating unnecessary formalities; providing for a single method for creating security rights rather than a

multiplicity of security devices; and permitting security rights in after-acquired property without additional actions on the part of the parties.

**C. Validate non-possessory security rights**

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

**D. Establish clear and predictable priority rules**

14. A security right will have little or no value to a creditor unless the creditor is able to ascertain priority in the property relative to other creditors (including an insolvency administrator for the grantor). Thus, the Guide proposes clear rules that allow creditors to determine and establish the priority of their security rights at the outset of the transaction in a timely and cost-efficient manner.

**E. Facilitate enforcement of creditor's rights in a predictable and timely fashion**

15. 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 timely fashion. In addition, the involvement of courts in the enforcement process can be time-consuming. In view of these facts, the Guide proposes rules that allow creditors to enforce their security rights upon the occurrence of a default in a timely, predictable and cost-efficient manner, and with an appropriate level of court control.

**F. Provide for equal treatment of domestic and non-domestic creditors**

16. Because healthy competition among all potential creditors (both domestic and non-domestic) is an effective way of driving down the cost of credit, the Guide recommends that the regime apply equally to domestic and non-domestic creditors.

**G. Recognize party autonomy**

17. 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. In order to achieve this goal, the Guide stresses the importance of party autonomy, while at the same time protecting the legitimate interests of all parties (especially consumers).

**H. Encourage responsible behaviour by enhancing transparency**

18. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules.