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Report of the Secretary-General

Addendum

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VII. Priority

A. General remarks

1. The concept of priority and its importance

1. The term “security right,” as used in this Guide, refers to an *in rem* right (i.e. a right in property granted to a creditor to secure the payment or other performance of an obligation). The term “priority,” on the other hand, refers to the extent to which the creditor may derive the economic benefit of that right in preference to other parties claiming an interest in the same property see A/CN.9/WG.VI/WP.2/Add.1, para. 9, definition of “priority”). As discussed below, these competing claimants may include holders of consensual security rights in the property, holders of unsecured debt, sellers of the property, buyers of the property, holders of non-consensual security rights in the property (such as security rights arising from judgements or created by statute) and the insolvency administrator of the grantor.

2. The concept of priority is at the core of every successful legal regime governing security rights. While some have questioned why one creditor should ever be given priority over another creditor, it is widely recognized that a priority rule is necessary to promote the availability of low-cost secured credit. Moreover, a clear priority rule that leads to predictable outcomes allows all creditors, even unsecured creditors, to assess their positions in advance of extending credit and to take steps to protect their rights.

3. A creditor will normally extend credit on the basis of the value of specific property only if the creditor is able to determine, with a high degree of certainty at the time it extends the credit, the extent to which other claims will rank ahead of its security right in the property. The most critical issue for the creditor in this analysis is what its priority will be in the event of the grantor’s insolvency, especially where the encumbered asset is expected to be the creditor's primary or only source of repayment. If the creditor has any uncertainty with respect to its priority at the time it is evaluating whether to extend credit, the creditor will place less reliance on the encumbered asset. At a minimum, this uncertainty will increase the cost of the credit to reflect the diminished value of the encumbered asset to the creditor, and may even cause the creditor to refuse to extend the credit altogether.

4. To limit this uncertainty, it is important that secured lending laws include clear priority rules that lead to predictable outcomes. The existence of such rules,

together with efficient mechanisms for ascertaining and establishing priority at the time credit is advanced, may be more important to creditors than the particulars of the priority rules themselves. It often will be acceptable to a creditor if certain competing claimants have priority, as long as the creditor can determine, with a high degree of certainty, that it will ultimately be able to realize a sufficient portion of the value of the encumbered assets to repay its claim in the event of non-payment by the grantor. For example, a creditor may be willing to extend credit to a grantor based upon the value of the grantor's existing and future inventory, even though the inventory may be subject to the prior claims of the vendor who sold the inventory to the grantor, or the warehouseman who stored the inventory for the grantor, as long as the creditor can determine that, even after paying such claims, the inventory may be sold or otherwise disposed of for an amount sufficient to repay its secured obligation in full.

5. It is important to note that no matter what priority rule is in effect in any jurisdiction, it will only have relevance to the extent that the applicable conflict-of-laws rules provide that such priority rule governs. This issue is discussed in Chapter XI.

2. Priority rules

a. First-to-file priority rule

6. As discussed above (see paras. 2-4), in order to effectively promote the availability of low-cost credit, consideration should be given to establishing priority rules that permit creditors to determine their priority with the highest degree of certainty at the time they extend credit. As discussed in Chapter V and Chapter VI (see A/CN.9/WG.VI/WP.2/Add.5, paras. …, and Add.6, paras. …), the most effective way to provide for such certainty is to base priority on the use of a public filing system.

7. In many jurisdictions in which there is a reliable filing system, priority is generally determined by the order of filing, with priority being accorded to the earliest filing ("first-to-file priority rule"). In some situations, this rule applies even if all of the requirements for the creation of a security right have not been satisfied at the time of the filing, which avoids the need for a creditor to search the filing system again after all remaining requirements for creation have been satisfied. This rule provides the creditor with certainty that once it files a notice of its security right, no other filing, except for the limited exceptions discussed in section A.3 below, will have priority over its security right. This certainty allows creditors to assess their priority position with a high degree of confidence, and as a result, reduces their credit risk. Other creditors are also protected because the filing will put them on notice of the security right, or potential security right, and they can then take steps to protect themselves. The first-to-file priority rule does not apply in some cases (e.g. to purchase money security rights, discussed in section A.3.c. below, or to statutory creditors, discussed in section A.3.f. below).

8. This first to file priority rule is illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.2/Add.2, paras. 10 and 13). In these examples, Lender B and Lender C each have a security right in all of Agrico's existing and after-acquired

inventory and receivables. Under a first-to-file priority rule, the lender that filed a notice of its security right in the inventory and receivables first would have priority over the other lender's security right, regardless of the time that each lender's security right was obtained.

9. Some jurisdictions provide that, as long as filing occurs within a certain "grace period" after the date on which the security right is created, priority will be based on the date of creation rather than on the date of filing. Thus, a security right that is created first, but filed second, may still have priority over a security right that is created second but filed first, as long as the first security right is filed within the applicable grace period. As a result, until the grace period expires, the filing date is not a reliable measure of a creditor's priority ranking, thus resulting in significant uncertainty. In legal systems in which no such grace periods exist, creditors are not at a disadvantage because they can always protect themselves by making a timely filing.

10. In principle, the ordering of priority according to the timing of filing should apply even if the creditor acquired its security right with actual knowledge of an existing unfiled security right. Qualifications based on actual knowledge require a fact-specific investigation and would subject filings to challenge, creating a new issue for litigation and an incentive to attack filings. All this would diminish certainty as to priority status and thereby reduce the efficiency and effectiveness of the system. As in the case of grace periods, there is no unfairness to secured creditors in this approach because they can always protect themselves by making a timely filing.

b. Priority based on possession or control

11. As discussed in Chapter IV and Chapter V (see A/CN.9/WG.VI/WP.2/Add.3, paras. 5-14, and Add.4, paras. 2 and 52-54), possessory security rights traditionally have been an important component of the secured lending laws of most jurisdictions, and should be considered in crafting a priority rule. In recognition of this, in certain systems that have a first-to-file priority rule, priority alternatively may be established based on the date that the creditor obtained its security right by possession or control, without any requirement of a filing. In these systems, priority is generally afforded to the creditor that first either filed notice of its non-possessory security right in the filing system or obtained a security right by possession or control.

12. If priority may be established by date of possession or control, or alternatively by the date of filing, consideration should be given to whether a security right obtained by possession or control should ever have priority over a previously filed non-possessory security right. In the case of certain types of encumbered assets, creditors often require possession or control to prevent prohibited dispositions by the grantor. For example, creditors often require possession or control of instruments such as certificated investment securities or documents of title such as warehouse receipts and negotiable documents. For these types of assets, it may be most efficient for a security right established by possession or control always to have priority over a non-possessory security right, regardless of the date of the filing of the non-possessory security right. For other

types of assets, consideration should be given to according priority to the first creditor to file a notice of its security right or obtain possession or control of the ecumbered asset.

13. The availability of alternative modes of establishing priority (i.e. control, possession and filing) raises the question of whether a secured creditor who initially established priority by one method should be permitted to change to another method, without losing its original priority ranking with respect to the encumbered asset. In principle, there is nothing objectionable about this, provided there is no gap in the continuity of control, possession or filing (i.e. at all times the security right is subject to one method or another).

c. Alternative priority rules

14. In some systems, priority is based on the date that the security right is created as opposed to the date of filing (a different first in time rule). This approach has been adopted in some jurisdictions that permit non-possessory security rights but have not adopted a reliable, or any, filing system. In these jurisdictions, a creditor is not able to confirm independently whether there are any competing security rights and must rely solely upon representations of the grantor as to the absence of such rights. This serves as a major impediment to the availability of low-cost secured credit.

15. In other systems, with respect to certain types of assets such as receivables, priority is based on the time that specified third parties are notified of the security right. Like the system described in the preceding paragraph, this system also is not conducive to the promotion of low-cost secured credit because it does not permit the creditor to determine, with a sufficient degree of certainty at the time it extends credit, whether there are any competing security rights.

3. Types of competing claimants

a. Other consensual secured creditors

16. As discussed above (see paras. 2-4), many legal systems allow the grantor to grant more than one security right in the same asset, basing the relative priority of such security rights on the priority rule (first to file or other) in effect under such system or on the agreement of the creditors. Allowing multiple security rights in the same asset in this manner enables a grantor to use the value inherent in a single asset to obtain credit from multiple sources, thereby unlocking the maximum borrowing potential of the asset.

b. Unsecured creditors

17. The grantor will often incur debts that are not secured by security rights. These general unsecured claims often comprise the bulk of the grantor's outstanding obligations.

18. While some question the fairness of giving secured creditors priority over unsecured creditors, it is well established that giving secured creditors priority over

unsecured creditors is necessary to promote the availability of secured credit. Unsecured creditors can take steps to protect their interests, such as monitoring the status of the credit, requiring security in certain instances or reducing their claims to judgements (as discussed in section A.3.e. below) in the event of non-payment. In addition, obtaining secured credit increases the capital of the grantor, which in many instances benefits the unsecured creditors by increasing the likelihood that the unsecured debt will be repaid. Thus, an essential element of an effective secured credit regime is that secured claims, properly obtained, have priority over general unsecured claims.

c. Sellers of encumbered assets

i. Purchase money security rights

19. Typically, the grantor acquires its assets by purchasing them. If the purchase is made on credit provided by the seller or is financed by a lender ("purchase money financing"; see A/CN.9.WG.VI/WP.2/Add.2, paras. 2-4, and Add.3, paras. 31-32) and the seller or lender obtains a security right in the goods acquired to secure the purchase money financing, consideration must be given to the priority of such rights *vis á vis* security rights in the same goods held by other parties.

20. Recognizing that purchase money financing is an effective means of providing businesses with capital necessary to acquire specific goods, many legal systems provide that holders of purchase money security rights have priority over other creditors (including creditors that have an earlier in time filed security right in the goods) with respect to goods acquired with the proceeds of the purchase money financing. This is a significant exception to the first-to-file priority rule discussed in section A.2.a. above.

21. This heightened priority is important in promoting the availability of purchase money financing. As illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.2/Add.2, paras. 10 and 13), businesses often grant security rights in all or some of their existing and after-acquired inventory and equipment to obtain financing. In these situations, if purchase money security rights are not afforded a heightened priority, purchase money financiers would not be able to place significant reliance on their security rights because they would rank behind existing security rights. In example 1 (see A/CN.9/WG.VI/WP.2/Add.2, paras. 4-7), Vendor A, Lender A and Lessor A would each be reluctant to provide purchase money financing if their security rights in the goods financed ranked behind the existing security rights of Lender B in example 2 and Lender C in example 3.

22. Providing heightened priority for purchase money security rights is generally not considered to be detrimental to the grantor's other creditors, because purchase money financing does not diminish the estate (i.e. the net assets or net worth) of the grantor, but instead provides the estate with additional assets in return for the purchase money obligations. For example, the security positions of Lenders B and C in examples 2 and 3 are not diminished by a purchase money financing, because the Lenders still have all of their encumbered assets plus a security right ranking behind the additional goods financed by the purchase money credit transaction ("junior security right"). In order to promote the availability of both purchase

money financing and general secured credit, it is important that the heightened priority afforded to purchase money security rights only apply to the goods acquired with such purchase money and not to any other assets of the grantor.

23. To avoid other creditors mistakenly relying on assets subject to purchase money security rights, it is important that purchase money security rights be subject to the filing system (see A/CN.9/WG.VI/WP.2/Add.5, paras. …). From the perspective of a competing creditor, it would be beneficial if a notice of such security rights was required to be filed at the time the rights were obtained. This would mean that any creditor could search the filing system and determine with certainty whether any of the grantor's existing assets are subject to purchase money security rights.

24. However, in order to facilitate on-the-spot financing in the sales and leasing sectors, a grace period for the filing should be considered. This grace period should be long enough so that the filing requirement is not an undue burden to purchase money financiers, but short enough so that other secured creditors are not subject to long periods before they are able to determine if any competing security rights exist. In addition, it may be wise to require purchase money financiers of inventory to give notice of their purchase money security rights to the grantor's other creditors that have security rights in inventory. The reason for such an approach lies in the fact that creditors who provide credit on a continual basis based on the value of a grantor's existing and future inventory are unlikely to search the filing system each time they extend credit.

ii. Reclamation claims

25. Consideration might also be given to allowing a supplier that sells goods on unsecured credit to reclaim the goods from the buyer within a specified period of time if the supplier discovers within that time that the buyer is insolvent. Although the supplier will want such period to be as long as possible to protect its interests, other creditors will be reluctant to provide credit based on assets subject to reclamation claims. Moreover, if the supplier is truly concerned about the credit risk, the supplier could insist upon a purchase money security right in the goods that it supplies on credit. Accordingly, although a reclamation claim is important so that suppliers can have some rights in the goods that they supply on unsecured credit, the reclamation period should be brief so that it does not impede secured lending generally.

d. Buyers of encumbered assets

26. The grantor may also sell assets that are subject to existing security rights. In this situation the buyer has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold. It is important that a priority rule address both of these interests.

i. Sales outside the ordinary course of business of the grantor

27. In many countries, sales of encumbered assets outside the ordinary course of business of the grantor do not destroy any security rights that the secured creditor has in the assets, unless the secured creditor consents. In those jurisdictions, the secured creditor may, upon a default by the grantor, enforce its security right against the assets in the hands of the buyer. Without this protection, the rights of the secured creditor would be jeopardized any time that the grantor sells assets. This result would reduce the value of the encumbered assets as security, thereby impeding the availability of low-cost credit.

28. Even if the creditor would have a security right in the proceeds arising from the sale of the assets, the secured creditor would not necessarily be sufficiently protected, because proceeds often are not as valuable to the creditor as the original encumbered assets. In many instances, the encumbered assets may be sold in return for assets that have little or no value to the creditor as security. In other instances, it would be difficult for the creditor to identify the proceeds, and as result, its claim to the proceeds may be illusory. Also, there is a risk that the proceeds may be dissipated by the grantor, leaving the creditor with nothing.

29. As long as the creditor's security right is subject to filing in a reliable and easily accessible filing system, the buyer may protect itself by searching the filing system to determine whether the asset it is purchasing is subject to a security right, and if so, seek a release of the security right from the secured creditor. Consideration might be given to whether any low-cost items should be exempted from this rule because the search costs imposed on potential buyers may not be justified for such items. On the other hand, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in arbitrary line-drawing and would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors. As a result, it may be best not to provide for such an exemption.

30. In some countries that have a filing system that is searchable only by the grantor's name, rather than by a description of the encumbered assets, a purchaser who purchases the assets from a seller who previously purchased the assets from the grantor ("remote purchasers") obtains the assets free of the security rights granted by such grantor. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset, and accordingly, have no reason to conduct a search against the previous owner.

ii. Sales made in the ordinary course of business of the grantor

31. An exemption to the rule discussed in section A.3.d.i. above is generally provided for goods held as inventory of the grantor and sold in the ordinary course of the grantor's business. For such goods, there is a commercial expectation that the grantor will sell them (and indeed must sell them to remain viable), and that the buyer of the encumbered assets will take them free and clear of existing security

rights. Without such an exemption, a grantor's ability to sell goods in the ordinary course of its business would be greatly impeded, because buyers would have to investigate claims to the goods prior to purchasing them. This would result in significant transaction costs and would greatly impede ordinary course transactions.

32. As a consequence, many legal systems provide for an exception to the general rule of continuity of security rights in favour of buyers of encumbered assets if the sale is made in the ordinary course of the grantor's business and the asset being sold constitutes inventory of the grantor. To promote such ordinary course transfers, many legal systems provide that buyers in such transactions obtain the assets free and clear of any security right, even if the buyer had actual knowledge of the security right. This exception, however, is limited in some jurisdictions if the buyer had knowledge that the sale was made in violation of an agreement between the seller and its creditor that the assets would not be sold without the consent of the creditor.

e. Judgement or execution creditors

33. In many legal systems, a security right is extended to certain classes of creditors felt to be deserving of such a right. In particular, many legal systems give a security right to general unsecured creditors once they have reduced their claim to judgement and have caused the seizure of specific property.

34. In this situation, an existing creditor that has an earlier in time consensual security right in certain assets has an interest in making sure that its security right retains its priority over the security right obtained by a judgement, particularly with respect to assets it has already relied upon in extending credit. On the other hand, the judgement creditor has an interest in receiving priority with respect to assets that have sufficient value to serve as a source of repayment of its claim.

35. Many legal systems that have a filing system rank priority in this situation by time of filing of the security right, i.e. an earlier in time filed consensual security right in property will have priority over a subsequent security right in the same property obtained by judgement. Conversely, any attempt to grant a consensual security right in the property after a creditor has obtained some form of a judgement security right will result in an interest that is junior to the existing judgement security right. This approach is generally acceptable to creditors as long as the judgement security right is made sufficiently public so that creditors can become aware of it in an efficient manner and factor its existence into their credit decision before extending credit. To facilitate this, consideration should be given to subjecting judgement security rights to the general filing system for security rights, thus integrating them into the first-to-file priority regime.

36. There is generally an exception to this rule when it is applied to future advances (discussed in greater detail in section A.4.a. below). While a previously filed security right customarily will have priority over a judgement security right with respect to credit advanced prior to the date that the judgement security right becomes effective, it will generally not have priority over the judgement security right with respect to any credit advanced after such effective date (unless such credit had been committed prior to the effective date of the judgement). For example, in

example 2 (see A/CN.9/WG.VI/WP.2/Add.2, para. 10), Lender B makes loans from time to time to Agrico, which are secured by all of Agrico's receivables and inventory. If an unsecured creditor reduces its claim to a judgement against Agrico and thereby obtains a security right in Agrico's inventory, Lender B's security right in the inventory would have priority over the judgement security right with respect to loans that Lender B made prior to the date that the judgement became effective and for a specified period thereafter. However, the judgement security right would have priority with respect to any additional loans made by Lender B after the specified period (as long as Lender B did not commit prior to the effective date of the judgement to extend such additional loans).

37. To protect existing secured creditors from making additional advances based on the value of assets subject to judgement security rights, there should be some mechanism to put creditors on notice of such judgement security rights. In many jurisdictions in which there is a filing system, this notice is provided by subjecting judgement security rights to the filing system. If there is no filing system or if judgement security rights are not subject to the filing system, the judgement creditor might be required to notify the existing secured creditors. In addition, it may be provided that the existing secured creditor's priority continues for a period of time (perhaps forty-five to sixty days) after the judgement security right is filed (or after the creditor receives notice) so that the creditor can take steps to protect its interest accordingly. The less time an existing secured creditor has to react to the existence of judgement security rights and the less public such judgement security rights are made, the more their potential existence will impede the availability of credit facilities that provide for future advances.

f. Statutory (preferential) creditors

38. In many jurisdictions, as a means of achieving a general societal goal, certain unsecured claims are given priority over other unsecured claims, and in some cases, over secured claims (including secured claims that previously have been the subject of a filing). For example, to protect claims of employees and the Government, claims for unpaid wages and unpaid taxes often will, at some point, be given priority over previously existing security rights. Because societal goals differ from jurisdiction to jurisdiction, the types of these claims, and the extent to which they are afforded priority, also differ.

39. The advantage of establishing these preferential claims is that a societal goal may be furthered. The possible disadvantage is that these types of priorities can proliferate in a fashion that reduces certainty among existing and potential creditors, thereby impeding the availability of low-cost secured credit. To avoid discouraging secured credit, the availability of which is also a societal goal, the various societal goals should be carefully weighed in deciding whether to provide a preferential claim. Preferential claims should only be provided to the extent that there is no other effective means of satisfying the underlying societal goal and the impact on the availability of low-cost credit is acceptable. If preferential claims exist, the laws establishing them should be sufficiently clear so that a creditor is able to calculate the potential amount of the preferential claims and to protect itself.

g. Creditors adding value to or storing encumbered assets

40. Some legal systems provide that creditors who improve or fix encumbered assets, such as equipment repairers, have security rights in the encumbered assets they improve or fix, and that such security rights generally rank ahead of other secured claims in the encumbered assets. This priority rule has the advantage of inducing those who supply such value to continue in their efforts, and also has the advantage of facilitating the maintenance of the encumbered assets. As long as the amount that these security rights secure is limited to an amount that reflects the value by which the encumbered asset has been enhanced, such security rights and their elevated priority should be unobjectionable to existing secured creditors.

41. Some systems also provide that creditors who store encumbered assets, such as landlords and warehousemen, have security rights in the encumbered assets to secure the rental and storage obligations, and such security rights often rank ahead of other secured claims in the same encumbered assets.

42. In many jurisdictions, the rights described in the preceding two paragraphs are not subject to any filing requirement, and their existence can only be discerned through due diligence on the part of a prospective creditor. As a result, these security rights are often referred to as being "secret". While secret security rights have the advantage of protecting the rights of the parties to whom they are granted without requiring such parties to incur the costs associated with filing, they pose a significant impediment to secured credit because they limit the ability of creditors to determine competing security rights. As discussed in Chapter V and Chapter VI (see A/CN.9/WG.VI/WP.2/Add.5, paras. …, and Add.6, paras. …), consideration should be given to requiring that notice of such security rights be filed in the security right filing system.

h. Insolvency administrators

43. It is particularly important that a secured creditor be able to determine what its priority will be in the event that an insolvency proceeding is commenced by or against its grantor, because there most likely will not be sufficient assets to pay all creditors and the secured creditor's encumbered assets may be its primary, or only, source of repayment. As a result, in deciding to extend credit and in evaluating priority, secured creditors generally place their greatest focus on what their priority will be in an insolvency proceeding of the grantor. Therefore, it is important that the priority of a properly obtained security right not be diminished or impaired in an insolvency proceeding. The importance of this point in crafting an effective secured transactions law cannot be over-emphasized. To the extent that secured credit laws are not clear on this point, the willingness of creditors to provide secured credit will be seriously diminished.

44. In order to effectively compensate insolvency administrators for their work in the insolvency proceeding, they often are given a preferential claim in the assets of the insolvent estate. As long as the amount of this preferential claim can be determined by secured creditors in advance with a high degree of certainty, this claim is generally not objectionable to secured creditors, because they can take actions in advance to protect their claims. However, the greater this potential

preferential claim, the less value prospective secured creditors will attribute to the encumbered assets.

45. As discussed in greater detail in Chapter X (see A/CN.9/WG.VI/WP.2/Add.10, paras. …), insolvency laws in many jurisdictions contain provisions that empower an insolvency administrator to challenge, within a limited period of time, the validity or priority of consensual security rights based upon factors such as lack of consideration to the grantor, the inequitable conduct of the creditor or the fact that the security right was granted in violation of a particular law. It is important to emphasize that any successful security regime must be meshed effectively with applicable insolvency laws so that a prospective creditor may properly structure its credit transaction in compliance with such laws in order to ensure that the effectiveness and priority of its security right is maintained in the case of the grantor's insolvency.

4. Priority in future advances and after-acquired property

a. Future advances

46. A secured creditor must be able to determine how much of its claim will be accorded priority. Some legal systems limit this priority to the amount of debt existing at the time of the creation of the security right. Other legal systems require publicity of the maximum amount of credit that will be extended priority. Yet other legal systems accord priority for all extensions of credit, even those made after creation of the security right.

47. The advantage of limiting priority to the amount of debt originally in existence at the time that the security right was created is that it matches priority with the contemplation of the parties at the time of creation, and preserves only that priority against creditors then in existence. The disadvantage of this approach is that it requires additional due diligence (e.g. searches for new filings), and additional agreements and filings for amounts subsequently advanced. This is particularly problematic because one of the most effective means of providing secured credit is on a revolving basis because this type of credit facility most efficiently matches the grantor's particular borrowing needs (see example 2 in A/CN.9/WG.VI/WP.2/Add.2, paras. 8-10, and Add.4, para. 10). Accordingly, consideration might be given to affording to future advances the priority afforded to advances made at the time that the security right is first created.

48. To avoid tying up all the grantor's assets with one creditor, thus reducing willingness with which subsequent creditors may extend credit to the grantor, many legal systems require that security right filings set forth a maximum amount of debt that may be secured by any given security right, and limit priority to such maximum amount (see A/CN.9/WG.VI/WP.2/Add.6, paras. …). To avoid hindering the advancement of revolving credits as discussed above (see para. 47) or any other similar form of credit, consideration might be given to not limiting the amount to which future advances are afforded priority.

b. After-acquired property

49. As discussed in greater detail in Chapter IV (see A/CN.9/WG.VI/WP.2/Add.4, paras. 19-23), in some legal systems a grantor may provide for a security right in property to be acquired in the future. Such a security right is obtained simultaneously with the grantor's acquisition of the property, without any additional steps being required each time additional property is acquired. As a result, the costs incident to the grant of a security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory, which is acquired for resale, receivables, which are collected and re-generated on a continual basis (see example 2 in A/CN.9/WG.VI/WP.2/Add.2, paras. 8-10) and equipment, which is replaced in the normal course of the grantor's business.

50. The allowance of security rights in after-acquired property raises the question of whether the priority dates from the time of the initial grant or from the time the grantor acquires the property. Different systems address this matter in different ways. Some systems vary the effect depending on the status of the creditor competing for priority (with priority dating from the date of the grant *vis-à-vis* other consensual security creditors, and from the date of acquisition *vis-à-vis* all other creditors). Whatever the rule, it is important that it be clear so that creditors can protect their interests accordingly.

5. Priority in proceeds

51. If the creditor has a right in proceeds of the original encumbered asset, issues will arise as to the status and priority of that right as against other competing claimants. Apart from the competing claimants mentioned already, competing claimants with respect to proceeds may include a creditor of the debtor who has obtained a right by judgement or execution against the proceeds and another creditor who has a security right in the proceeds.

52. A security right in proceeds can arise in two ways. The debtor may have granted the competing secured creditor a security right in the proceeds after the debtor acquired the proceeds; or the proceeds are a type of property in which the competing secured creditor has a pre-existing interest that covers after-acquired or future collateral. For example, creditor A has a security right in all of the debtor's inventory and creditor B has a security right in all of debtor's receivables (including future receivables). Assume further that the debtor later sells inventory that is subject to the security interest of creditor A and that this sale is on credit. The receivable generated by the sale is proceeds of the encumbered asset of creditor A and is the encumbered asset of creditor B.

53. The legal system governing security rights must answer several questions with respect to the claim of the secured creditor as against each of the above-mentioned competing claimants. The first question is whether the right of the secured creditor in the proceeds of its initial encumbered asset is effective not only against the grantor but also against competing claimants. The answer to this question must be affirmative, at least in some circumstances. Otherwise, the value of encumbered assets would be largely illusory. Security rights add economic

security (thereby increasing access to credit at lower cost) only in cases in which the security right provides the creditor with the right to apply the value of the encumbered asset to the debt owed to the creditor before that value is applied to claims of other claimants.

54. Nonetheless, it must be recognized that the creation of a right in proceeds raises important concerns about the risks created for third parties. In particular, considerations that lead to a requirement of publicity for a security right in particular property to be effective against third parties may lead to a conclusion that similar requirements are appropriate for the right in proceeds.

55. Therefore, a legal regime should contain rules that determine when the publicity that is given to the security right in the original encumbered asset will suffice to publicize the creditor's right in the proceeds. In cases in which a different mode of publicity is required for the creditor's interest in the proceeds, the legal regime should provide a period of time after the transaction generating the proceeds in which the creditor may provide the publicity without losing its interest in the proceeds.

56. While determination of whether a new act of publicity is necessary in order for the creditor's right in proceeds to be effective against third parties is quite important, that determination alone is not sufficient to resolve the relative rights of the secured creditor's right in proceeds. In particular, priority rules are needed to determine the relative priority of the secured creditor's right.

57. The priority rules may differ depending on the nature of the competing claimant. For example, if the competing claimant is another secured creditor whose rights are also dependent on publicity, the rules determining the relative priority of the rights of the two secured creditors might depend on the nature and timing of the publicity. Priority may depend on other factors when the competing claimant is a judgement creditor or an insolvency administrator (see paras. 33-37).

58. In many cases in which the competing claimant is another secured party, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to the original encumbered asset and the policies that generated those rules. For example, in a legal system in which the first right in particular property that is publicized has priority over competing rights, that same rule could be used to determine the priority when the original encumbered asset has been transferred and the secured creditor now claims a right in proceeds. If the right in the original encumbered asset was publicized before the right of the competing claimant in the proceeds was publicized, that right could be given priority.

59. In cases in which the order of priority of competing interests in the original encumbered asset is not determined by the order of publicity, a separate determination will be necessary for the priority rule that would apply to the proceeds of such original encumbered asset. This might be the case, for example, if one of the competing rights in the original encumbered asset is a security right securing the purchase price of the encumbered asset and, accordingly, awarded higher priority than would otherwise be the case.

6. Voluntary alteration of priority: subordination agreements

60. The priority enjoyed by any secured creditor need not be unalterable. In many systems, priority may be, and frequently is, altered by private contract. As an example, a lender with a security right in all existing and after-acquired assets of a grantor could agree that the grantor might give a first priority security right in a particular asset so that the grantor could obtain additional financing from a source other than the lender based on the value of that asset.

61. Such agreements altering priority are perfectly acceptable as long as they affect only the parties who actually consent to such alterations. Subordination agreements should not affect the rights of creditors who are not parties to the agreement. Additionally, it is important that the priority afforded by a subordination agreement continue to apply in an insolvency proceeding of the grantor.

7. Relevance of priority prior to enforcement

62. Another important issue pertaining to priority is whether priority only has relevance after the occurrence of an event of default by the grantor in the underlying obligation or whether priority also has relevance prior to default. Many jurisdictions allow the holder of a junior consensual security right to receive a regularly scheduled payment on its obligation *before* the secured obligation having priority is paid in full, absent a contrary agreement between the senior and junior claimant. If the junior claimant were to be required to remit the payment, this would be a major impediment to the junior claimant providing financing.

63. The result may be different if the junior claimant received proceeds from the collection, sale or other disposition of the collateral. In that circumstance, some jurisdictions require the junior claimant to remit the proceeds to the senior claimant if the junior claimant received the proceeds with the knowledge that the grantor was required to remit them to the senior claimant. The rationale behind this rule is similar to the rationale discussed in section A.3.d. above with respect to buyers of encumbered assets.

B. Summary and recommendations

64. The concept of priority is a critical component in any secured lending regime that seeks to promote the availability of low-cost secured credit. The availability of credit is dependent on the ability of creditors to determine, with a high degree of certainty prior to extending credit, what their priority will be if they attempted to realise their security. Because such realisation often occurs in an insolvency proceeding of the grantor, it is critical that a secured creditor's priority continue unimpaired in the insolvency proceeding.

65. It is therefore important that secured lending laws include priority rules that are clear and lead to predictable outcomes. These rules should allow all creditors, even unsecured creditors, to assess their positions in advance of extending credit and to take steps to protect their interests. Clear priority rules that result in

predictable outcomes and efficient mechanisms for ascertaining and establishing priority at the time credit is advanced may be more important to creditors than the particulars of the priority rule itself.

66. This result may be achieved most effectively by establishing a filing system and basing priority according to the first to file a notice of a security right. In addition, assuming that the filing system is reliable and easily accessible, it may provide an effective mechanism for alerting creditors to competing security rights.

67. Exceptions to the first-to-file priority rule should only be considered to the extent that there is no other means to satisfy the underlying policy objective of the exception and that objective justifies the impact of the exception on the availability of low-cost credit. Any such exceptions should be stated clearly, allowing creditors to assess the likelihood of any preferential claims and to take steps to protect themselves with respect to such claims. In order to most effectively alert creditors as to competing claims, consideration should be given to subjecting all claims, including preferential claims, to the security right filing system. Some important exceptions to the first-to-file priority rule that should be addressed in crafting secured transactions laws pertain to purchase money security rights, creditors that add value to collateral (such as equipment repairers) and possibly also certain claimants (such as wage and Governmental claimants) that legislatures may wish to protect to achieve general societal goals.

68. Recognizing priority with respect to future advances and after-acquired property is likely to encourage the availability of revolving and other similar credits to businesses. The simpler the procedure for a creditor to establish priority with respect to future advances and after-acquired property, the greater will be the availability of these credits.

69. At least, in certain circumstances, the right of the secured creditor in the proceeds of its encumbered assets should be effective not only as against the grantor but also as against competing claimants. A legal regime should provide when a publicity act with respect to the security right suffices to publicize the creditor's rights in the proceeds or when a new publicity act is required. In addition, a legal regime should include priority rules with respect to rights in proceeds. Such rules may differ depending on the nature of the competing claimant.

70. Regardless of the priority rules of any secured transactions regime, creditors should be permitted to vary such rules by private contract in order to structure financing arrangements that best suit the grantor's needs. Such agreements should be recognized as effective among the parties thereto in an insolvency proceeding commenced by or against the grantor; however, they should not affect the rights of persons who are not parties to such agreements.

71. Finally, secured transactions regimes should specify the circumstances in which the holders of junior security rights in specific encumbered assets will be prevented from taking actions that are inconsistent with the rights of the holders of senior security rights in the same assets. Examples of such actions include retaining proceeds from the sale or other disposition of such assets with knowledge of the grantor's contractual obligation to remit those proceeds to the senior secured creditor.