United Nations A/CN.9/WG.VI/WP.9/Add.7

General Assembly

Distr.: Limited
13 June 2003

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
Fourth session
Vienna, 8-12 September 2003

Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

Contents

	Paragraphs	Page
Draft legislative guide on secured transactions	1-37	2
X. Conflict of laws	1-37	2
A. General remarks	1-29	2
1. Introduction	1-9	2
a. Purpose of conflict-of-laws rules	1-5	2
b. Scope of conflict-of-laws rules	6-9	3
2. Conflict-of-laws rules for creation, publicity and priority	10-17	4
3. Effect of subsequent change in the connecting factor	18-22	6
4. Conflict-of-laws rules for enforcement issues	23-28	6
5. The impact of insolvency on conflict-of-laws rules	29	7
B. Summary and recommendations	30-37	8

V.03-85070 (E) 260603 270603

X. Conflict of laws

A. General remarks

1. Introduction

a. Purpose of conflict-of-laws rules

1. This Chapter discusses the rules for determining the law applicable to the creation, publicity, priority and enforcement of a security right. These rules are generally referred to as conflict-of-laws rules and also determine the territorial scope of the substantive rules envisaged in the Guide (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Guide apply). For example, if a State has enacted the substantive law rules envisaged in the Guide relating to the priority of a security right, these rules will apply to a priority contest arising in the enacting State only to the extent that the conflict-of-laws rule on priority issues points to the laws of that State. Should the conflict rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State, and not pursuant to the substantive priority rules of the enacting State.

2. After a security right has become effective, a change might occur in the connecting factor for the choice of the applicable law. For instance, if security over tangible goods located in State A is governed by the law of the location of the goods, the question arises as to what happens if those goods are subsequently moved to State B (whose conflict rules also provide that the location of the goods governs security rights over tangible property). One alternative would be for the security to continue to be effective in State B without the need to take any further step in State B. Another alternative would be for new security to be obtained under the laws of State B. Yet another alternative would be for the secured creditor's pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (e.g. 30 days after the goods have been brought into State B). These issues are addressed by the conflict-of-law rules of some legal systems. This Chapter proposes a general rule in this regard.

3. Conflict-of-laws rules should reflect the objectives of an efficient secured transactions regime. Applied to the present Chapter, this means that the law applicable to the property aspects of a security right should be capable of easy determination: certainty is a key objective in the elaboration of rules affecting secured transactions both at the substantive and conflict-of-laws levels. Another objective is predictability. As illustrated by the questions in the preceding paragraph, the conflict-of-laws rules should permit the preservation of a security right acquired under the laws of State A if a subsequent change in the connecting factor for the selection of the applicable law results in the security right becoming subject to the laws of State B. A third key objective of a good conflict-of-laws system is that the relevant rules must reflect the reasonable expectations of interested parties (creditor, grantor, debtor and third parties). According to many, in order to achieve this result, the law applicable to a security right should have some connection to the factual situation that will be governed by such law.

4. Use of the Guide (including this Chapter) in developing secured transactions laws will help reduce the risks and costs resulting from differences between current

conflict-of-laws rules. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place (including in a jurisdiction administering the insolvency of the grantor). If those States have different conflict-of-laws rules in relation to the same type of encumbered assets, the creditor will need to comply with more than one regime in order to be fully protected. A benefit of different States having harmonized conflict-of-laws rules is that a creditor can rely on one single law to determine the priority status of its security in all such States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention and in respect of indirectly-held securities by the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

5. It is worth noting that conflict-of-laws rules would be necessary even if all States had harmonized their secured transactions laws. There would remain instances where the parties would have to identify the State whose requirements will apply. For example, if the laws of all States provided that publicity of a non-possessory right is made by filing in a public registry, one would still need to know in which State's registry the filing must be made.

b. Scope of the conflict-of-laws rules

6. This Chapter does not define the security rights to which the conflict-of-laws rules will apply. Normally, the characterization of a right as a security right for conflict-of-laws purposes will reflect the substantive security rights law in a jurisdiction. In principle, a court will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule. The question arises, however, as to whether the conflict-of-laws rules for security rights should also apply to other transactions that are functionally similar to security, even if they are not covered by a secured transactions regime. To the extent that title reservation agreements, financial leases, consignments and other similar transactions would not be governed by the substantive law provisions governing secured transactions, a State might nonetheless subject these devices to the conflict-of-laws rules applicable to secured transactions.

7. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation, publicity and priority be the same as for a security right over the same category of property. An example is found in the United Nations Assignment Convention, which (including its conflict-of-laws rules) applies to outright transfers of receivables as well as to security rights over receivables (see art. 2 (a)). This policy choice is motivated, inter alia, by the necessity of referring to one single law to determine priority between competing claimants to the same receivable. In the event of a priority dispute between a purchaser of a receivable and a creditor holding security over the same receivable, it would be more difficult (and sometimes impossible) to determine who is entitled to priority if the priority of the purchaser were governed by the laws of State A but the priority of the secured creditor were governed by the laws of State B.

8. Whatever decision a jurisdiction makes on the range of transactions covered by the conflict-of-laws rules, the scope of the rules will be confined to the property aspects of these transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the creation of a property right. The rule would not apply to the personal obligations of the parties under their contract.

Such obligations are governed by the law applicable to contractual obligations, which subject to certain limitations, most legal systems permit the parties to freely choose in their contract.

9. A corollary to recognizing party autonomy with respect to the personal obligations of the parties is that the conflict-of-laws rules applicable to the property aspects of secured transactions are matters that are outside the domain of freedom of contract. For instance, the grantor and the secured creditor cannot be permitted to select the law applicable to priorities, since this could not only affect the rights of third parties, but also result in a priority contest between two competing secured creditors being subject to two different laws leading to opposite results.

2. Conflict-of-laws rules for creation, publicity and priority

10. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis:

(a) The first issue is whether the security has been validly created (see Chapter IV);

(b) The second issue is whether the security is effective against third parties (see Chapter V); and

(c) The third issue is what is the priority ranking of the secured creditor (see Chapter VI).

11. Not all legal systems make specific conceptual distinctions among these issues. In some legal systems, the fact that a property right has been validly created necessarily implies that the right is effective against third parties. Moreover, legal systems that clearly distinguish among the three issues do not always establish separate substantive rules on each issue. For example, in the case of a possessory pledge complying with the requirements for the *in rem* validity of a security right generally results in the security being effective against third parties without any need for further action.

12. The key question is whether one single conflict-of-laws rule should apply to all three issues. The alternative is to allow for more flexibility, where it may be more appropriate that the law applicable to publicity or priority be different from that governing the creation of the right. Policy considerations, such as simplicity and certainty, favour adopting one rule for creation, publicity and priority. As noted above, the distinction among these issues is not always made or understood in the same manner in all legal systems, with the result that providing different conflict-of-laws rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding non-consensual security.

13. Another important question is, whether on any given issue (i.e. creation, publicity or priority) the relevant conflict-of-laws rule should be the same for tangible and intangible property. A positive answer to that question would favour a rule based on the law of the location of the grantor. The alternative would be the place where the encumbered asset is held (*lex situs*), which would, however, be inconsistent in respect of receivables with the United Nations Assignment

Convention (article 22 of which refers to the law of the State in which the assignor, i.e. the grantor, is located).

14. Simplicity and certainty considerations support the adoption of the same conflict-of-laws rule (e.g. the law of the grantor's location) for both tangible and intangible property, especially if the same law applies to creation, publicity and priority. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right over the same property governed by the law of State B).

15. Not all jurisdictions, however, regard the law of the location of the grantor as sufficiently connected to security rights over tangible property (for "non-mobile" goods at least). Moreover, the law governing security would need to be same as the law governing a sale of the same assets. This means that acceptance of the grantor's law for every type of security would be workable only if jurisdictions, generally, were prepared to accept that rule for all transfers.

16. In addition, it is almost universally accepted that a possessory right should be governed by the law of the place where the property is held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor's location were to be the general rule, an exception would need to be made for possessory security rights.

17. As the applicable conflict rules might be different depending on the tangible or intangible character of the assets or the possessory or non-possessory nature of the security, the question arises as to which conflict rule is appropriate if intangible property is capable of being the subject of a possessory security right. In this regard, most legal systems assimilate certain categories of intangibles incorporated in a document (such as negotiable instruments and bills of lading) to tangible property, thereby recognizing that such assets may be pledged by delivering the document to the creditor. The pledge would then be governed by the law of the State where the document is held.

[***Note to the Working Group***

The scope of the law envisaged by this Guide is focused on commercial goods, equipment and trade receivables. If the Working Group decides to cover other categories of intangible property, such as non-trade receivables, bank deposits, letters of credit and intellectual property, it may wish to consider whether there should be any special conflict rules for these types of asset. In considering the matter, the Working Group may wish to take into account that assets within these categories of property often comprise a significant part of the value of an enterprise and that in particular the absence of a conflict-of-laws rule for intellectual property could cause great difficulties in commercial transactions.

With respect to conflict rules applicable to securities, the Working Group may wish to refer to the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.]

3. Effect of subsequent change in the connecting factor

18. Whatever connecting factor is retained for determining the most appropriate conflict-of-laws rule for any given issue, there might occur a change in the relevant factor after the security has been created. For example, where the applicable law is that of the jurisdiction where the grantor has its head office, the grantor might later relocate its head office to another jurisdiction. Similarly, where the applicable law would be the law of the jurisdiction where the secured property was located, the property might be moved to another jurisdiction.

19. If these issues are not dealt with specifically, an implicit rule might be drawn. The general conflict-of-laws rules on creation, publicity and priority might be construed to mean that, in the event of a change in the relevant connecting factor, the original governing law continues to apply to issues that arose before the change (e.g. creation), while the subsequent governing law would apply to events occurring thereafter (e.g. a priority issue between two competing claimants).

20. The silence of the law on these matters might, however, give rise to other interpretations. For example, one interpretation might be that the subsequent governing law also governs creation in the event of a priority dispute occurring after the change (on the basis that third parties dealing with the grantor are entitled to determine the applicable law for all issues relying on the actual connecting factor, being the connecting factor in effect at the time of their dealings).

21. Providing a rule on these issues would appear to be necessary to avoid uncertainty, in particular where the connecting factor changes from a State that has not enacted the law envisaged by this Guide to an enacting State.

22. A similar issue arises with respect to goods in transit. Some legal systems provide that a security right over such goods may be validly created and publicized under the law of the place of destination if they are moved to that place within a specified time limit.

4. Conflict-of-laws rules for enforcement issues

23. Where a security right is created and publicized under the law of one State, but is sought to be enforced in another State, an issue arises regarding what remedies are available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security could allow enforcement by the secured creditor without prior recourse to the judicial system unless there is a breach of peace, while the law of the place of enforcement might require judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

24. One option is to subject enforcement remedies to the law of the place of enforcement, i.e. the law of the forum (*lex fori*). The policy reasons in favour of this rule include that:

(a) The law of remedies would coincide with the law generally applicable to procedural issues;

(b) The law of remedies would, in many instances, coincide with the location of the property being the object of the enforcement (and could also coincide with the law governing priority if the conflict-of-laws rules of the relevant State point to the location for priority issues);

(c) The requirements would be the same for all creditors intending to exercise rights against the assets of a grantor, irrespective of whether such rights are domestic or foreign in origin.

25. On the other hand, the *lex fori* might not give effect to the intention of the parties. The parties' expectations may be that their respective rights and obligations in an enforcement situation will be those provided by the law under which the security was created. For example, if extra-judicial enforcement is permitted under the law governing the creation of the security, it would also be available to the secured creditor in the State where the latter has to enforce its security, even if it is not generally allowed under the domestic law of that State.

26. An approach based on the reasonable expectations of the parties would suggest a rule referring enforcement issues to the law governing the creation of the security right. This solution would also avoid separating the remedies from the nature of the rights conferred by a security. Such a separation is not evident where the remedies are closely linked to the attributes of the security (for instance, the remedies of a conditional seller may be viewed as stemming from the fact that it has remained the legal owner of the goods). To the extent that the conflict-of-laws rule on priority issues would be the same as for creation and publicity, another benefit of the law regarding creation of the security and the law governing enforcement coming from the same regime would be that priority and enforcement issues would be subject to the same law.

27. A third option is to adopt a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This would often correspond to their expectations and, in many instances, would also coincide with the law applicable to the creation of the security right since that law is often selected as also being the law of the contract. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum or the law governing creation, publicity and (or) priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the property of their common debtor.

28. Therefore, referring enforcement issues to the law governing the contractual relationship of the parties would necessitate exceptions designed to take into account the interests of third parties, as well as the mandatory rules of the forum, or of the law governing validity and publicity. Procedural matters would, in any case, need to be governed by the law of the forum. As a result, the various enforcement issues would be treated differently.

5. The impact of insolvency on conflict-of-laws rules

29. As pointed out in the Insolvency Chapter (A/CN.9/WG.VI/WP.9/Add.6, para. …), in general a security right effective against the grantor and third parties outside of insolvency should continue to be effective in insolvency proceedings. Similarly, the occurrence of insolvency should not displace the conflict-of-laws

rules applicable to the creation, the publicity and, subject to some exceptions, the priority of a security right.

[***Note to Working Group***

Consideration might also be given to the impact of insolvency on any conflict-of laws rule for enforcement measures, and whether this Guide should deal with this issue or whether it is more appropriately dealt with in the Guide on Insolvency.]

B. Summary and recommendations

30. The creation, publicity and priority of a possessory security right over tangible property, money, negotiable documents of title and negotiable instruments are governed by the law of the State in which the encumbered asset is located.

31. The creation, publicity and priority of a non-possessory security right over intangible property are governed by the law of the State in which the grantor is located.

32. With respect to a non-possessory security right over tangible property, the following alternatives may be considered:

Alternative 1

The creation and publicity of a non-possessory security right over tangible property are governed by the law of the State in which the grantor is located, but the priority of such a security right is governed by the law of the State in which the encumbered asset is located.

Alternative 2

The creation, publicity and priority of a non-possessory security right over tangible property are governed by the law of the State in which the encumbered asset is located, except for mobile goods where such issues are governed by the law of the State in which the grantor is located.

33. If a State adopts alternative 2, it might wish to consider an additional rule for goods in transit which would provide that a security right over such goods may be validly created and publicized under the law of the place of destination provided that they are moved to that place within a certain time limit.

34. The above rules do not specifically refer to proceeds, on the assumption that the conflict-of-laws rules for proceeds should, in principle, be the same as those applicable to a security right initially obtained over the same type of property.

35. A security right validly created and publicized under the law of a State other than the enacting State continues to be valid and publicized in the enacting State after the connecting factor changes to the enacting State, if the publicity requirements of the enacting State are complied with within a specified grace period. This rule would imply that creation issues continue to be governed by the initial governing law while publicity (and priority to the extent that priority is

governed by the same law as publicity) would be governed, after the change, by the law of the enacting State.

36. With regard to the law applicable to enforcement issues, the following alternatives may be considered:

Alternative 1

Substantive matters affecting the enforcement of the rights of a secured creditor are governed by the law of the State where enforcement takes place.

Alternative 2

Substantive matters affecting the enforcement of the right of a secured creditor are governed by the law governing the creation [and the priority] of the security right.

Alternative 3

Substantive matters affecting the enforcement of the rights of a secured creditor are governed by the law governing the contractual relationship of the creditor and the grantor, with the exception of […].

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