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Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum*

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* This addendum is submitted three weeks and four days less than the required ten weeks prior to the start of the meeting because of the need to accommodate the completion of consultations.



XI. Transition issues

A. General remarks

1. The need for transition provisions

1. The rules embodied in new secured transactions legislation will be different from the rules in the law predating the legislation. Those differences will have an obvious impact on secured transactions that take place after the new legislation is enacted. The effect of the new legislation on existing transactions entered into prior to the new legislation must also be considered. In light of the differences between the old and new legal regimes and the continued existence of transactions and security rights created under the old regime, it will be important for the success of the new legislation that it contain fair and efficient rules governing the transition from the old rules to the new rules. In this context, two related, but distinct, issues must be addressed. First, the new legislation should provide the date as of which it will have legal effect (the “effective date”). Second, the new legislation should also set forth the extent, if any, to which, after the effective date, the new legislation applies to issues relating to transactions or security rights that existed before the effective date.

2. A number of factors require consideration in determining the effective date of the legislation. Prompt realization of the economic advantages of new legislation must be balanced against the need to avoid causing instability in, or disruption of, the markets that will be governed by new legislation and in allowing the market participants adequate time to prepare for conducting transactions under the new legislation, which may be significantly different from the prior law. Accordingly, the State may conclude that the effective date of new legislation should be some period of time after the enactment of the new legislation in order for these markets and their participants to adjust their transactions to the new rules. In determining the effective date, States might consider: the impact of the effective date on credit decisions; maximization of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonization of the new secured transaction legislation with other legislation; constitutional limits to the retroactive effect of new legislation; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

3. As debts that are secured by rights in the grantor’s property are often payable over a period of time, it is likely that there will be many rights created before the effective date that will continue to exist on and after the effective date, securing debts that are not yet paid. Therefore, as noted above, another important decision that must be made with respect to any new legislation is the extent, if any, to which the new legislation will govern issues relating to transactions entered into prior to the effective date.

4. One approach would be for the new legislation to apply prospectively only and, therefore, not to govern any transactions entered into prior to the effective date. While there is a certain logical appeal in such a solution, especially with respect to issues that arise between the grantor and the secured creditor, such an approach

would create significant problems, especially with respect to priorities. Foremost among those problems would be the necessity of resolving priority disputes between a secured creditor which obtained its security right prior to the effective date and a competing secured creditor which obtained its security right in the same property after the effective date. Because priority is a comparative concept, and the same priority rule must govern the two rights that are being compared, it is not possible for the old rules to govern the priority of the interest of the pre-effective date creditor and the new rules to govern the priority of the interest of the post-effective date creditor. Determining which priority rule to apply to such priority disputes is not without difficulty. Applying the old rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new legislation, with the result that significant economic benefits of the new legislation could be deferred for a substantial period. On the other hand, applying the new rules to such priority disputes might unfairly prejudice parties which relied on the old law and might also provide an incentive for such parties to object to the new legislation or advocate an unduly delayed effective date.

5. Alternatively, greater certainty and earlier realization of the economic benefits of the new legislation could be promoted by applying the new legislation to all transactions as of the effective date, but with such “transition provisions” as are necessary to assure an effective transition to the new regime without loss of pre-effective date priority status. Such an approach would avoid the problems identified above and would otherwise fairly and efficiently balance the interests of parties which complied with the old law with the interests of parties which comply with the new law.

2. Issues to be addressed by transition provisions

a. Generally

6. Because many security rights created before the effective date will continue to exist after the effective date, and may come into conflict with security rights created after the effective date, it is important for the new legislation to provide clear transition provisions to determine the extent to which the rules in the new legislation will apply to those pre-existing rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction creating a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between holder of a security right and a competing claimant, when either the security right, or the interest of the competing claimant, was created before the effective date.

b. Effectiveness of pre-effective date rights as between the parties

7. When a security right has been created before the effective date of new legislation, two questions arise regarding the effectiveness of that right between the grantor and the creditor. The first is whether a right that was not effective between the parties under the old law, but would be effective if the new law applied should become effective on the effective date of the new law. The second question is whether a right that was effective between the parties under the old law but would

be ineffective if the new law applied should become ineffective between the parties on the effective date of the new law. Such an approach would recognize that the new legislation's rules for effectiveness between the parties comprise the State's most current policy choices as to the requirements for effectiveness, taking into account the protections of the transacting parties, and that as a general matter the parties themselves would presumably favour effectiveness of a transaction that they entered into. With respect to the first question, consideration should be given to making the right effective as of the effective date of the new law. With respect to the second question, a transition period might be created during which the security right would remain effective between the parties, so that the creditor could take the necessary steps during the transition period to make the right effective under the new law. At the expiration of the transition period, the right would become effective between the parties under the new law.

c. Effectiveness of pre-effective date rights as against third parties

8. Different issues are raised as to the effectiveness against third parties of a right created before the effective date. As new legislation will embody public policy regarding the proper steps necessary to make a right effective against third parties, it is preferable for the new rules to apply to the greatest extent possible. It may, however, be unreasonable to expect a creditor whose right was effective against third parties under the previous legal regime to comply immediately with any additional requirements of the new law. The expectation would be especially onerous for institutional creditors, which would be required to comply with the additional requirements of the new law simultaneously for large numbers of pre-effective date transactions. A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules, should remain effective for a reasonable period of time (as set forth in the new law) so as to give the creditor time to take the necessary steps under the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law.

9. If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new rules, the right should be effective against third parties immediately upon the effective date of the new rules. Once again, the presumption is that the parties intended effectiveness as between them, and third parties are protected to the full extent of the new rules.

d. Priority disputes

10. An entirely different set of questions arises in the case of priority disputes because such disputes necessarily involve applying one set of rules to two (or more) different rights created at different times. A legal system cannot simply provide that the priority rule in effect at the time when a right was created governs priority with respect to that right. Rather, there must be rules that address each of the following situations: (i) where both rights are created after the effective date of the new legislation, (ii) where both rights are created before the effective date, and (iii) where one right is created before the effective date and the other right is created after the effective date.

11. The easiest situation, of course, is a priority dispute between two parties both of whose rights were created after the effective date of the new legislation. In that situation, it is obvious that the priority rules in the new legislation should be applied to resolve that dispute.

12. Conversely, if both of the competing rights were created before the effective date of the new legislation (and, accordingly, the relative priority of the two competing rights in the encumbered assets was established before the effective date of new rules) and, in addition, nothing (other than the effective date having occurred) has happened that would change that relative priority, stability of relationships suggests that the priority established before the effective date should not be changed. If, however, something occurs after the effective date that would have had an effect on priority even under the previous legal regime, there is less reason to continue to utilize old rules to govern a dispute that has been changed by an action that took place after the effective date. Therefore, there is a much stronger argument for applying the new rules to such a situation.

13. The most difficult transition situation involves a priority dispute between one party whose right was established before the effective date and another party whose right was established after the effective date. In such a case, while it is preferable to have the new rules govern eventually, it is appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the old regime while that creditor takes whatever steps are necessary to maintain protection under the new regime. If those steps are taken within the requisite time, the new legislation should provide that creditor with priority to the same extent as would have been the case had the new rules been effective at the time of the original transaction and those steps had been taken at that time.

e. Disputes before a court or arbitral tribunal

14. When a dispute is in litigation (or a comparable dispute resolution system) at the effective date, the rights of the parties have sufficiently crystallized so that the effectiveness of a new legal regime should not change the outcome of that dispute. Therefore, such a dispute should not be resolved by application of the new legal regime.

B. Summary and recommendations

15. New secured transactions legislation should specify a date, subsequent to the enactment of the legislation, as of which it will enter into force (the “effective date”).

16. A State might take into account the following considerations in determining the effective date: the impact of the effective date on credit decisions; maximization of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonization of the new secured transaction legislation with other legislation; the content of constitutional rules with respect to pre-effective date transactions; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

17. The new legislation should provide a period of time after the effective date (the “transition period”), during which creditors with security rights effective against the grantor and third parties under the previous regime may take steps to assure that those rights are effective against the grantor and third parties under the new legislation. If those steps are taken during the transition period, the legislation should provide that the effectiveness of the creditor’s rights against those parties is continuous.
18. The new legislation should provide clear rules for resolving: (i) which law applies to the priority between post-effective date rights; (ii) which law applies to the priority between pre-effective date rights; (iii) which law applies to the priority between pre-effective date and post-effective date rights.
19. The new legislation should provide that priority between post-effective date rights is governed by the new legislation.
20. The new legislation should provide generally that priority between pre-effective date rights is governed by the former legal regime. The legislation might also provide, however, that application of those former rules will occur only if no event occurs after the effective date that would have changed the priority under the former regime. If such an event occurs, the new legislation would determine priority.
21. With respect to priority between pre-effective date rights and post-effective date rights, the new legislation should apply as long as the holder of a pre-effective date right may, during the transition period, ensure priority under the new legislation by taking whatever steps are necessary under the new legislation. During the transition period, the priority of the pre-effective date right should continue as though the new legislation had not become effective. If the appropriate steps are taken during the transition period, the holder of the pre-effective date right should have priority to the same extent as would have been the case had the new rules been effective at the time of the original transaction and those steps had been taken at that time.
22. When a dispute is in litigation (or a comparable dispute resolution system) at the effective date of the new legislation, the rights of the parties should not be resolved by application of the new legal regime.