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Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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* This document is submitted three weeks later than the required ten weeks prior to the start of the meeting because of the need to complete consultations and to finalize consequent amendments.



XVI. Security rights in bank accounts

A. General remarks (continued)

[Note to the Working Group: Part A. General remarks, Sections 1 to 8, are contained in document A/CN.9/WG.VI/WP.18.]

8. Rights and duties of the depositary bank (continued)

Other rights and duties of the depositary bank

61. In those circumstances in which the secured creditor is not the depositary bank's customer with respect to the bank account and the depositary bank's consent is required for the creation of a security right in the bank account, for the security right to be effective against third parties, for the security right to have priority or for the secured creditor to enforce the security right, the depositary bank may have no duty under the law of the applicable State to provide the consent.

62. Even when the secured creditor is able to enforce the security right against the depositary bank, the depositary bank may have a right to recoup or set-off any funds in the bank account that might otherwise be claimed by the secured creditor against obligations owed by the grantor to the depositary bank. Indeed, the entitlement of the secured creditor to the funds in the bank account may always be subordinate to depositary bank's right of recoupment or set-off unless the depositary bank has agreed otherwise.

63. Moreover, the depositary bank may have no duty under the laws of a particular State to reorder its favourable priority contractually by subordinating its right of recoupment or set-off, or by subordinating any security right which it may obtain automatically in the bank account as a depositary bank, to the security right of another creditor of the grantor.

64. Of course, even if, to facilitate the creation as between the parties, effectiveness against third parties, priority and enforcement of a security right in a bank account, the secured creditor is willing to become the depositary bank's customer with respect to the bank account, the depositary bank may have no duty to accept the secured creditor as the bank's customer.

Position of the depositary bank justifying not imposing duties on the depositary bank without its consent

65. While it may seem unjustified for a secured transactions law not to impose various duties upon the depositary bank with respect to the security right without the depositary bank's consent, nevertheless the alternative of imposing such duties as a rigid legal rule may subject the depositary bank to undue risks that it is not in a position to manage without having appropriate safeguards in place.

(a) The depositary bank is subject to significant operational risks, with funds being debited or credited to bank accounts on a daily basis, often with credits being made on a provisional basis, and sometimes involving other transactions with its customers;

(b) These risks are compounded by legal risk to the depositary of failing to comply with laws dealing with negotiable instruments, wire transfers and other

payments systems rules in its day to day operations as well as the risk of not complying with certain duties imposed on the depositary bank by other laws, such as laws requiring it to maintain the confidentiality of its dealings with its customers;

(c) In addition, the depositary bank is typically subject to regulatory risk under laws and regulations of the State designed to insure the safety and soundness of the depositary bank;

(d) The depositary bank is also subject to reputational risk in choosing which customers with which it agrees to enter into transactions.

66. Given these risks faced by the depositary bank, and its need to implement and maintain appropriate safeguards to manage those risks, a rule that imposes duties on the depositary bank with respect to a security right in a bank account only with depositary bank's consent is understandable and well justified.

67. The experience in those States where the depositary bank's consent to such duties is required suggests that the parties are often able to negotiate satisfactory arrangements so that the depositary bank is comfortable that it is managing the risks involved given the nature of the transaction and of the bank's customer.

9. Relationship with insolvency law

68. The secured transactions law of a State which recognizes a security right in a bank account should set forth rules to relate the secured transactions law to the insolvency law of the State.

69. The secured creditor holding a security right in a bank account will normally be subject to the rules applicable in the grantor's insolvency proceeding. For example, the secured creditor will typically still be subject to rules in the grantor's insolvency proceeding relating to any stays of enforcement against the grantor, preferential or fraudulent transfer and the like. Under some circumstances, the grantor's insolvency administrator may, notwithstanding that the secured creditor's security right otherwise is effective against third parties and has priority, be entitled to draw funds from the bank account for use in the insolvency proceeding so long as the secured creditor is given a security right in other assets of equal value or the value of the security right is otherwise protected.

70. Even if for some reason the insolvency tribunal does not have jurisdiction over the secured creditor, the secured creditor may in practical effect find itself subject to the rules applicable in the grantor's insolvency proceeding to the extent that the insolvency tribunal has jurisdiction over the depositary bank and the depositary bank may not, under the insolvency rules, honour the instructions from the secured creditor as to the funds in the bank account without the consent of the insolvency administrator or the insolvency tribunal.

10. Conflict of laws

71. The law of a State that recognizes a security right in a bank account should provide clear rules that address conflict-of-laws issues relating to security rights in bank accounts.

72. States have taken different approaches to address conflict-of-laws issues involving security rights in bank accounts. Under the laws of some States, all issues

relating to security rights in bank accounts are governed by the law of the State in which the grantor is located, typically the State in which the central administration of the grantor is exercised or the State in which the grantor habitually resides (see article 5 (h) of the Assignment Convention).

73. Under the laws of other States, all issues relating to security rights in bank accounts are governed by the law of the State in which the depositary bank is located. The depositary bank would typically be located in the State in which it has its place of business or, if the depositary bank has a place of business in more than one State, in the State which has the closest relationship with the secured transaction. It is possible, however, that the law of a particular State may permit the grantor and the depositary bank to designate the State in which the depositary bank is considered to be located for purposes of its secured transactions law.

74. A few States take a bifurcated approach. Under this approach, issues relating to the effectiveness of the security right against the grantor and the enforcement of the security right against the grantor may be governed by the law of the State in which the grantor is located or perhaps by the law of the State applicable under the private international law rules for the contract creating the security right. Issues relating to the effectiveness of the security right against third parties and the priority of the security right, to the extent not involving the acknowledgment, consent or agreement of the depositary bank or the secured creditor becoming the bank's customer with respect to the bank account, may in turn be governed by the law of the State in which the grantor is located. However, under a bifurcated approach any issues relating to the effectiveness of the security right against third parties or priority of the security right requiring the acknowledgment, consent or agreement of the depositary bank or the secured creditor becoming the bank's customer with respect to the bank account, or relating to the rights and duties of the depositary bank with respect to the security right, may be governed by the law of the State in which the depositary bank is located or by the law of the State governing the agreement between the grantor and the depositary bank establishing the bank account.

75. The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "Hague Convention") suggests a modified approach. Under the Hague Convention, issues relating to the priority of a security right in a securities account and the rights and duties of the intermediary with respect to the securities account are determined by the law of the State whose laws govern the agreement between the grantor and intermediary establishing the securities account.

76. Given that it is sometimes difficult to determine whether an account maintained at a bank is a bank account or a securities account, it would seem to be most efficient for the conflict-of-laws rules relating to security rights in bank accounts to be as consistent as practicable with those relating to security rights in securities accounts. Accordingly, deference to the rules of the Hague Convention would appear to be appropriate and justifiable, i.e. that issues relating to the effectiveness of the security right in a bank account against third parties, the priority of the security right, the rights and duties of the depositary bank with respect to the bank account and the enforcement of the security right be determined by the law of the State whose laws govern the agreement with the depositary bank establishing the bank account. This approach, for purposes of determining the effectiveness against

third parties and priority of a security right in a bank account and the rights and duties of the depositary bank with respect to the security right, has substantially the same effect as it would under the laws of a State which permitted the grantor and the depositary bank to designate the State in which the depositary bank is considered to be located for purposes of its secured transactions law.

77. Another policy reason for referring to the law governing the agreement establishing the bank account is that anyone extending credit in reliance on a security right in a bank account will be well aware that the value of that bank account as an encumbered asset is dependent not only on whether the creditor's security right is effective, as a security right, against the grantor and third parties, but also on whether the bank account has any value. The value of the bank account will depend, in large part, on the right of the bank at which the account is maintained to diminish the value of the bank account by setting off its claims against the grantor against the balance in the bank account. Thus, the secured creditor will, as a practical matter, need to learn something about the bank's rights against the grantor under the law of the State that governs the bank account to ascertain the value of the security right. In the course of this investigation of matters governed by the law of that State, the secured creditor can take steps to learn whether a competing secured creditor has "control" over the bank account under the laws of that State because of an agreement with the bank. Accordingly, having effectiveness against third parties by "control" governed by the law of the State whose law governs the bank account does not place unfair burdens on those considering the extension of credit to the grantor.

78. It may be that, in deferring to the rules of the Hague Convention for security rights in deposit accounts, there may be instances in which a security right made effective against third parties by the making of a notice filing in a security rights registry is not recognized (an issue referred to in the context of a multi-unit State in article 12.2.b of the Hague Convention). For example, if the grantor is located in State A but the law governing the agreement between the grantor and the depositary bank establishing the bank account is that of State B, a notice filing made in State A may not be recognized as a method for making the security right effective against third parties under the material law of State B. Nevertheless, in other instances, such as where the grantor is located in the same State whose laws govern the agreement between the grantor and the depositary bank establishing the bank account and that State permits a security right to be effective against third parties by the making of a notice filing in the security rights registry of that State, the notice filing will be recognized.

79. An alternative rule might be to look to the law of the State of the grantor on issues relating to the effectiveness of the security right in a bank account against third parties, the priority of the security right, the rights and duties of the depositary bank with respect to the bank account and the enforcement of the security right. However, there may be practical objections to such an approach. A conflict-of-laws rule which looks to the law of the State of the grantor may possibly subject the depositary bank to differing material law rules depending upon the locations of its many customers. Such a result would increase the operational and other risks to the depositary bank in ways which would not seem justified. Indeed, avoiding the multiplicity of conflict-of-laws rules applicable to intermediaries was one of the goals of the Hague Convention itself. Moreover, if the conflict-of-laws rule looked

to the location of the grantor on such issues as priority, the inconsistency between the conflict-of-laws rules governing bank accounts and those governing security accounts may well create confusion in practice, especially in circumstances where it is not clear whether an account is a bank account or a securities account.

11. Conclusion

80. Security rights in bank accounts play an important role in many credit transactions. A modern secured transactions law should recognize security rights in bank accounts and provide clear rules for the creation as between the parties, effectiveness against third parties, priority and enforcement of the security rights. The law should address as well the rights and obligations of the depositary bank with respect to a security rights in bank accounts maintained with it. The legal rules should be integrated into the State's insolvency law and should provide conflict-of-laws rules to address cross-border transactions involving security rights in bank accounts.

B. Recommendations

81. The law should define a "bank account" that is governed by that law. The definition should distinguish a bank account from a negotiable instrument issued by the depositary bank and from a securities account maintained at the depositary bank.

82. Because it may be difficult at times to determine whether an account at a bank is a bank account or a securities account, the rules governing security rights in bank accounts should draw a clear distinction between a bank account and a securities account. [These rules should also be substantially identical to those governing security rights in securities accounts or, if not substantially identical, at least coordinated so that the security creditor may comply with a single set of rules to insure creation, third party effectiveness, priority and ability to enforce the security right. The law governing security rights in bank accounts should accordingly follow as much as practicable the recommended rules for security rights in securities accounts contained in the International Institute for the Unification of Private International Law (UNIDROIT) texts on Transactions on Transnational and Connected Capital Markets, including the draft Convention on Harmonised Substantive Rules regarding Securities held with an Intermediary.]

83. The requirements for the creation of a security right in a bank account should, as a general matter, permit a security right to be created in any type of bank account, including a transactional bank account and a bank account in which the depositary bank is the secured creditor. Generally the requirements for creation of the security right should be the same as the requirements for the creation of a security right in other encumbered assets. However, an anti-assignment term in an agreement between the grantor and the depositary bank should not prevent the creation of a security right in a deposit account so long as the depositary bank has no duty to recognize the secured creditor, and no obligations are otherwise imposed on the depositary bank with respect to the security right, without the depositary bank's consent. Moreover, the enacting State should consider whether and to what extent, consistent with its consumer-protection laws and policies, a security right in a bank account may be created by an individual grantor if the funds in the bank account or

the credit extended to the individual grantor is for the grantor's personal, family or household purposes.

84. A security right in a bank account should be effective against third parties when the security right has been created and either the secured creditor has made a notice filing in the security rights registry covering the bank account or has obtained control of the bank account.

85. A security right which has become effective against third parties by control should be superior in priority to a security right which has become effective against third parties by other methods, including by the making of a notice filing in the security rights registry. If the secured creditor is the depositary bank, the depositary bank's security right should have priority over any other security right unless the depositary bank otherwise agrees. Likewise, unless the depositary bank otherwise agrees, the depositary bank's right to recoup or setoff against the bank account obligations owed to the depositary bank by the grantor should have priority over the security right of another secured party other than a secured party who has become the customer of the depositary bank with respect to the bank account.

86. A transferee of funds from a bank account should take free of a security right in the bank account.

87. A secured creditor whose security right in a bank account is enforceable against third parties on account of the secured creditor obtaining control of the deposit account should generally be permitted to enforce the security right against the grantor without the need for judicial process or court supervision. Any exceptions should be clearly stated and should generally relate only to the case where the State permits a security right in a bank account to be granted by an individual and the funds in the bank account or the credit secured by the security right is for the grantor's personal, family or household purposes.

88. A depositary bank should not be required to enter into a control agreement without its consent and should not be required to assume any other duties with respect to a security right in a bank account without the depositary bank's consent.

89. Issues relating to the creation of a security right in a bank account as between the parties, the effectiveness of the security right against third parties, the priority of the security right over the rights of competing claimants, the rights and duties of the depositary bank with respect to the security right in the bank account, and the rules for enforcement of the security right should be determined by the law of the State whose laws govern the agreement between the account holder and the depositary bank establishing the bank account (i.e. the rule of the Hague Convention).

[Note to the Working Group: The Working Group may wish to consider whether reference should be made instead to the law of the grantor's location (see article 22 of the Assignment Convention) or another law. The Working Group might also wish to consider whether reference might be made to the law of the grantor's location for effectiveness against third parties based upon filing of a notice in a secured transactions registry even if reference is made for all other issues to the law of the State whose laws govern the agreement between the account holder and the depositary bank establishing the bank account.]