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Security Interests

Recommendations of the draft Legislative Guide on Secured Transactions

Note by the Secretariat

Addendum

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V. Effectiveness of the security right against third parties

Purpose

The purpose of the provisions of the law on the effectiveness of a security right against third parties is to establish a foundation for the predictable, fair and efficient ordering of priorities by:

- (a) Relying on a simple, cost-efficient and effective public registry system for the registration of notices of non-possessory security rights;
- (b) Requiring registration or delivery of possession as a pre-condition to the effectiveness of a security right against third parties;
- (c) Identifying appropriate exceptions and alternatives to registration or delivery of possession in the light of countervailing practical considerations.

General methods for achieving third-party effectiveness of security rights

35. The law should provide that, except as otherwise provided in the recommendations of this chapter and the chapter on acquisition financing devices, a security right, created [or to be created] in accordance with the recommendations in the chapter on creation, becomes effective against third parties:

- (a) If a notice with respect to the security right is registered in a general security rights registry, as provided in recommendations 48 to 57 ter;
- (b) If possession of tangibles is delivered by the grantor to the secured creditor, as provided in recommendations 38 to 40.

[Note to the Working Group: The Working Group may wish to note that, under recommendation 54, a notice with respect to a security right may be registered before the conclusion of a security agreement or before the relevant assets are acquired by the grantor or are produced. In such a case, the question arises as to whether third-party effectiveness should be achieved as of the time of registration or actual creation. If the Working Group considers that creation should be one of the requirements for achieving third-party effectiveness (i.e. if the bracketed language is deleted), the question arises as a question of priority between a security right that was registered before one or more of the requirements for its creation were satisfied and a security right that was created and made effective against third parties subsequently. If the legislator wishes to encourage early registration (making the registry more reliable), priority should be given to the first-registered security right even if one or more of the requirements for its creation had not been satisfied at the time of registration (see recommendation 63 in A/CN.9/WG.VI/WP.24/Add.4). Such an approach does not create a disadvantage for secured creditors that obtain a security right and make it effective against third parties subsequently, since they can always protect their interests by searching the registry and discovering registered notices of security rights.]

Special methods for achieving third-party effectiveness of security rights

35 bis. The law should provide that a security right in the following types of asset becomes effective against third parties as follows:

(a) In movable property, with respect to which title or a security right is established or evidenced by registration of a notice in the specialized title registry or by a notation in a title certificate, by registration or notation, as provided in recommendation 40 bis;

(b) In a right to drawing proceeds from an independent undertaking by control, as provided in recommendation 41;

(c) In a bank account, by control or registration, as provided in recommendations 42 and 43;

(d) In a negotiable document of title, by delivery of possession of the document to the secured creditor, as provided in recommendation 39, and in goods covered by a document through delivery of the goods under recommendation 35 or delivery of the document under recommendation 40;

(e) In proceeds, by achieving third-party effectiveness with respect to the original encumbered assets, as provided in recommendation 44;

(f) In fixtures, by registration, as provided in recommendation 45;

(g) In masses of goods or products, as provided in recommendation 47; and

(h) In consumer goods, upon creation of an [acquisition] security right in consumer goods as provided in recommendation [128 (see A/CN.9/WG.VI/WP.24/Add.5)].

[Note to the Working Group: The Working Group may wish to consider whether the exemption for registration agreed upon with respect to acquisition security rights in consumer goods should be extended to non-acquisition security rights in consumer assets (tangibles and intangibles).]

36. The law should confirm that different methods for achieving third-party effectiveness may be used for different items or kinds of encumbered assets, whether or not they are encumbered by the same security agreement or by separate security agreements.

Third-party effectiveness of other rights

37. The law should provide that the right of an assignee under an outright assignment of receivables becomes effective against third parties by registration of a notice of the right in the general security rights registry.

[37 bis. The law may also require registration of a notice in respect of the following rights for them to become effective against third parties:

(a) The title of a lessor under a lease that is not a financing lease but which extends for a term of more than one year;

(b) The title of a consignor under a commercial consignment in which the goods are consigned to a consignee as agent for sale other than an auctioneer or a consignee who does not act as a consignee in the ordinary course of business; and

(c) The title of a buyer under a sale of goods outside the ordinary course of the seller's business where the seller remains in possession of the goods for more than [thirty] [sixty] [ninety] days.]

[Note to the Working Group: The Working Group may wish to note that long-term leases and the other devices mentioned in recommendation 37 bis, which appears within square brackets, are not within the scope of the draft Guide. They are made subject to registration in the general security rights registry as they may compete with a security right. If the Working Group approves their inclusion in this chapter, the scope of the draft Guide may need to be adjusted. The Working Group may also wish to note that, with respect to third-party effectiveness of acquisition financing devices, recommendation 127 (unitary or non-unitary approach) will apply.]

Third-party effectiveness of a security right in tangibles by delivery of possession to the secured creditor

38. The law should provide that a security right in tangibles becomes effective against third parties through delivery of possession of the tangibles by the grantor to the secured creditor. [Delivery of possession should be actual and not constructive, fictive or symbolic, and it is sufficient only if an objective third-party can conclude that the tangibles are not in the actual possession of the grantor. Possession by a third-party constitutes sufficient delivery of possession only if the third person is not an agent or employee of the grantor and holds possession for or on behalf of the secured creditor.]

[Note to the Working Group: The Working Group may wish to consider whether the bracketed language would be necessary if the terminology section clarifies that possession or delivery of possession has to be actual and the commentary deals with possession by an agent or employee of the grantor. In addition, the Working Group may wish to note that, as the term “tangibles” covers negotiable instruments and negotiable documents (see A/CN.9/WG.VI/WP.22/Add.1, para. 21 (i)), recommendation 38 applies to third-party effectiveness of security rights in negotiable instruments and negotiable documents. As a result, a security right in a negotiable instrument or in a negotiable document is made effective against third parties by delivery of the instrument or the document to the secured creditor. Recommendations 39 and 40 add special rules with respect to third-party effectiveness of security rights in negotiable documents of title and goods covered by negotiable documents of title.]

Third-party effectiveness of a security right in a negotiable document

39. [The law should provide that a security right in a negotiable document becomes effective against third parties by delivery of possession of the document to the secured creditor.] If a security right in a negotiable document is effective against third parties, the corresponding security right in the goods covered by the document is also effective against third parties.

[Note to the Working Group: The first sentence of recommendation 39 is intended to reiterate a rule already expressed in recommendation 38 (for the sake of avoiding any doubt and completeness of recommendation 39). It appears within square brackets as it may not be necessary.]

Third-party effectiveness of a security right in goods covered by a negotiable document of title

40. The law should provide that a security right in goods, covered by a negotiable document, may be made effective against third parties either through delivery of possession of the goods under recommendation 38 or through delivery of possession of the document, as long as the document covers the goods.

Third-party effectiveness of a security right in movables with respect to which there is a specialized title registry or a title certificate system

40 bis. The law should provide that a security right in movable property, with respect to which title or a security right is established or evidenced by registration in a specialized title registry or in a title certificate system, becomes effective against third parties:

- (a) If it is registered in the title registry;
- (b) A notation of it is made on the title certificate; or
- (c) A notice with respect to that right is registered in the general security rights registry.

[Note to the Working Group: The Working Group may wish to note that the commentary will explain that registration, as provided in recommendation 40 bis, is the exclusive method for achieving third-party effectiveness (i.e. third-party effectiveness may not be achieved by possession), if so provided in the relevant special legislation. The Working Group may also wish to note that recommendation 40 bis is supplemented by recommendation 64 in A/CN.9/WG.VI/WP.24/Add.4, under which a security right registered in the specialized title registry or with respect to which a notation was made in a title certificate has priority over a security right registered in the general security rights registry.]

Third-party effectiveness of security rights in rights to drawing proceeds from independent undertakings

41. [See A/CN.9/WG.VI/WP.24/Add.2, recommendation 49.]

Third-party effectiveness of security rights in bank accounts

42. The law should provide that a security right in a bank account becomes effective against third parties:

- (a) If a notice with respect to that right is registered in the general security rights registry; or
- (b) If the secured creditor has control of the bank account.

43. If the secured creditor and the depositary institution are the same person, the law should provide that the secured creditor automatically has control upon the creation of the security right.

[Note to the Working Group: The Working Group may wish to note that the following definition will be added to the terminology: “a secured creditor has “control” with respect to a bank account where: (i) automatically upon the creation

of a security right where the depositary bank is the secured creditor; (ii) the depositary bank has concluded a control agreement with the secured creditor, according to which the bank has agreed to follow instructions from the secured creditor with respect to the bank account without further consent of the grantor; or (iii) the bank account is transferred to secured creditor so that the secured creditor becomes the bank's customer with respect to the bank account".

The Working Group may also wish to note that, according to recommendation 26 (see A/CN.9/WG.VI/WP.21), no obligations are imposed on the depositary bank without its consent. The Working Group may wish to add, in the creation chapter or in a separate chapter on the rights of third-party debtors, recommendations along the following lines:

"X. The law should provide that:

(a) A secured creditor's rights in a bank account are subject to the rights, under the law and practice that govern bank accounts, of the depositary bank;

(b) The rights of a transferee of a bank account are superior to a security right in a bank account acquired from the transferor or any prior transferor; and

(c) The rights of set-off of the depositary bank [supersede] [are not impaired by reason of] [are distinct from] any security rights it may have in a bank account.

"Y. The depositary bank is not obligated to:

(a) Pay any person other than a person that has control of the bank account;

(b) Respond to requests for information about whether a control agreement or a security right in its own favour exists and whether the grantor retained the right to deal with the account.

"Z. The law should provide that, if a secured creditor has control over a bank account, the secured creditor has the right to enforce the security right against the depositary bank."

The commentary will explain that these exceptions are designed to complement recommendations 76 and 77 (see A/CN.9/WG.VI/WP.24/Add.4), under which: (i) a secured creditor who has control of a bank account has priority over one who has merely registered a notice of its right in the general security rights registry, and (ii) the depositary bank has priority over other secured creditors except a secured creditor holding the account in its own name. These priority recommendations mean that third parties are taken to know that they cannot rely on a bank account as a primary source of security for extensions of credit or can do so only by obtaining a subordination agreement from the depositary bank or having the account entered in their own name. Consequently, the absence of publicity of the security right is not seen as problematic.]

Third-party effectiveness of security rights in proceeds

44. The law should provide that, if a security right in an encumbered asset is effective against third parties, a security right in any proceeds of the encumbered asset becomes effective against third parties as soon as the proceeds arise, provided that:

(a) The security right in the encumbered asset became effective against third parties by registration of a notice in the general security rights registry and remains effective; or

[Note to the Working Group: Paragraph (a) would not apply, for example, to a security right which was made effective against third parties by possession or by registration in a specialized title registry or by a notation on a title certificate.]

(b) The proceeds take the form of money, negotiable instruments, negotiable documents of title or bank accounts.

If neither (a) nor (b) applies, the security right in the proceeds is effective against third parties for [...] days after the proceeds arise and continuously thereafter, if it becomes effective against third parties by one of the methods referred to in recommendations 35 or 35 bis before the expiry of that time period.

Third-party effectiveness of security rights in fixtures

45. The law should provide that a security right in tangibles (other than negotiable instruments and negotiable documents) that are or to become fixtures to immovables or to movables becomes effective against third parties, if a notice with respect to that right is registered in the general security rights registry. A security right in fixtures in immovables may also become effective against third parties, if a notice of the security right is registered in the immovables registry.

[Note to the Working Group: The commentary will explain that the provision for registration in the immovables registry in order for a security right to take effect against third-party buyers or secured creditors dealing with the related immovable is designed to protect the integrity and reliability of the immovables registry system. This recommendation is supplemented by recommendation 83 in A/CN.9/WG.VI/WP.24/Add.4, under which a security right in tangibles (other than negotiable instruments and negotiable documents) that are or are to become fixtures in immovables that became effective against third parties by registration of a notice in the immovables registry under recommendation 45 has priority over a security right in the related immovable that became was registered subsequently.]

46. The law should also provide that, if a security right in an encumbered asset is effective against third parties at the time when the encumbered asset becomes a fixture, the security right remains effective against third parties thereafter.

Third-party effectiveness of security rights in masses of goods or products

47. The law should provide that, if a security right in an encumbered asset is effective against third parties at the time when the asset becomes part of a mass of goods or products, the security right in the mass or product remains effective against third parties thereafter.

[Note to the Working Group: The Working Group may wish to note that the issue of creation of a security right in a mass of goods or products is dealt with in recommendation 32 (see A/CN.9/WG.VI/WP.21).]

Characteristics of a general security rights registry

48. The law should provide for a general security rights registry that has the following characteristics:

(a) Registration is effected by registering a notice of the security right, containing only the information specified in recommendation 49, as opposed to a copy of the underlying security documentation;

(b) The record of the registry is centralized (i.e., it contains all notices of security rights registered under this law);

(c) The registration system is set up to permit the indexing and retrieval of notices according to the name of the grantor or according to some other reliable identifier of the grantor (e.g. identification or commercial registration number);

(d) The registry is open to the public;

(e) Reasonable public access to the registry is assured through such measures as:

(i) Setting fees for registration and searching at a cost-recovery level, [and publishing periodic audited statements of the expenses and revenues of the registration system];

(ii) Making modes and points of access to the registry widely available;

(iii) Preparing and disseminating guides to registration and searching procedures and generally educating the public about the existence and role of the registry; and

(iv) Establishing reliable and consistent service hours compatible with the needs of potential registry users;

(f) The registration system is administered and operated to facilitate speedy, cost-effective and effective registration and searching. In particular:

(i) A notice may be registered without verification or scrutiny by anybody other than the registrant of the validity, sufficiency and accuracy of its content;

(ii) A search may be made without the need for the searcher to justify the reasons for the search;

(g) To the extent the financial and infrastructural capacity of the State permits, the registration system is computer-based. In particular,

(i) Notices registered are stored in electronic form in a computer database;

(ii) Registrants and searchers have immediate access to the registry record by electronic or similar means, including Internet and electronic data interchange;

(iii) The system is programmed to minimize the risk of entry of incomplete or irrelevant information (e.g. by requiring essential data fields to be completed);

- (iv) The system is programmed to facilitate speedy and complete retrieval of information and to minimize the practical consequences of human error (for example, search algorithms are designed to display similar grantor names and to disregard generic terms for denoting the status of legal entities, e.g. “Inc.”, “Co.”, “LLP”, “Plc”);
- (h) Legal rules and operating procedures are designed to ensure the security and integrity of the registry record. In particular:
 - (i) A registrant can obtain a copy of the registration as soon as the registration information is entered so as to verify that the entry is accurate and complete;
 - (ii) The identity of registrants is verified in advance and evidence of identity is preserved;
 - (iii) [The registry] [The secured creditor] is obligated to forward a copy of a registration to the grantor named in the registration;
 - (iv) The registry is obligated to send a copy of any changes to a registration to the secured creditor named in the financing statement;
 - (v) Although the day-to-day operation of the registry may be delegated to a private authority, the State retains the responsibility to ensure that it is operated in accordance with the governing legal framework.
 - (vi) A back-up copy of the registry record is maintained so as to ensure that it can be reconstructed.
- (i) Provision is made for the allocation of liability for loss or damage caused by an error in the administration or operation of the registration and searching system. If the system is designed to permit direct registration and searching by registry users without the intervention of registry personnel, the responsibility of the registry with respect to an inaccurate or incomplete printed registration or search result is limited to a system malfunction.

Required content of registered notice

49. The law should require the registered notice to contain only:

- (a) The names (or other reliable identifiers) of the grantor and the secured creditor, and their addresses; where the name and address of the grantor is likely to yield an excessive number of potentially positive matches on a search, supplementary identification criteria may be [required] [permitted], for example, date of birth for individuals or company registration number for legal entities;
- (b) A description of the movable property covered by the notice in accordance with recommendations 51 to 53;
- (c) The duration of the registration in accordance with recommendation 56; and
- [(d) A statement of the maximum monetary amount for which the security right may be enforced [if the State determines that such information is helpful to facilitate subordinate lending.]]

Legal sufficiency of grantor name in a registered notice

50. The law should provide that the name or other identifier of the grantor entered on a registered notice is legally sufficient if the notice can be retrieved by searching the registry record according to the correct legal name or other identifier of the grantor. For this purpose, the law should specify rules for determining the correct legal name or other identifier of individuals and entities.

50 bis. Where the grantor is a legal entity, the law should provide that its legal name is the name that appears in the documents constituting the entity. Where the name of the grantor is listed in separate record maintained by the State, for example, a commercial or company register, the State may wish to set up links between the two registers to facilitate accurate data entry. Where the grantor is an individual, the State should provide detailed guidance on the authoritative source of the grantor's legal name (e.g. name appearing in birth certificate or passport or certificate of citizenship or residence issued by country of habitual residence, or, in the absence of the former, name appearing in at least two government issued documents, such as. driver's licence or social or medical insurance card).

Change in name or other identifier of the grantor

50 ter. The law should provide that, if the name of the grantor changes so that the notice is no longer sufficient as provided in recommendations 53 and 54:

(a) A security right in an encumbered asset, in which the grantor has rights on the date of the name change remains effective against third parties;

(b) A security right in an asset acquired by the grantor or created within [...] days after the date of the name change, is effective against third parties; and

(c) A security right in an asset acquired by the grantor or created more than [...] days after the date of the name change, is not effective against third parties unless the notice is amended to provide the new name of the grantor.

[Note to the Working Group: The Working Group may wish to note that recommendation 50 ter provides a short period within which third-party effectiveness is preserved with respect to assets acquired by the grantor or created. It is assumed that reasonable secured creditors should be able to discover the name change within that period. Alternatively, the Working Group may wish to consider that security rights in such after-acquired or after-created assets are not effective after the name change or after the secured creditor acquires or ought to acquire knowledge of the name change.]

Legal sufficiency of description of assets covered by a registered notice

51. The law should provide that a description of the assets covered by a registered notice is legally sufficient if it enables a third person to identify the assets covered by the notice separate from other assets of the grantor.

52. If the assets covered by the notice consist of a generic category or categories of movable property, the law should provide that a generic description is legally sufficient.

53. If the assets covered by the notice are all the present and after-acquired movable property of the grantor, the law should provide that it is legally sufficient

to describe the charged assets as “all movable property” or by using equivalent language.

Advance registration

54. The law should confirm that a registration may be made before or after the creation of the security right to which it relates.

One registration for multiple security agreements between the same parties

55. The law should confirm that a single registration is sufficient for security rights created by all security agreements entered into between the same parties to the extent they cover items or kinds of movable property that fall within the description contained in the registered notice.

Duration and renewal of registration

56. The law should specify the duration of registration or permit the duration to be selected by the registrant at the time of registration. The law should provide for the right of the registrant to renew the term of a registration before its expiry.

56 bis. [The law should provide that a registration takes effect when the information is entered into the registry record so as to be disclosed on a search of the registry record.]

[Note to the Working Group: The Working Group may wish to note that, if the registration system permits the submission of paper notices to the registry (as opposed to direct data entry by registrants), there will be some delay between receipt of the notice by the registrar and the time the information on the notice is entered into the record by registry staff so as to become available to searchers. In such circumstances, the question arises as to the time when the registration should be effective, the time of receipt of the notice at the registry or the time the notice is entered into the record and becomes available to searchers. If the registration is effective when received by the registrar, a search will not disclose all legally effective registrations. To protect the information needs of third parties, recommendation 56 bis, therefore, makes the time of registration concomitant with searchability. Although this puts the risk associated with any delay on the secured creditor, the secured creditor is in a better position to take steps to protect itself than third parties. Moreover, the recommendations earlier outlined on the design and operation of the registry should ensure speedy and efficient registration procedures. In a fully electronic system that requires no intervention by registry staff entry of the notice and its availability to searchers is virtually simultaneous and this problem is significantly reduced.]

Discharge of registration

57. The law should provide that, if no security agreement has been completed between the parties or if the security right has been terminated by full payment or performance of all of the secured obligations:

- (a) The secured creditor must discharge the registration within [...] days;
- (b) The grantor is entitled to compel discharge of a registration through a summary procedure;

(c) The grantor and the secured creditor may agree to discharge the registration.

57 bis. The law should provide that the registrar should remove a registration from the searchable records of the registry within a short period of time after a discharge is registered, but the information should be archived so as to be capable of retrieval if necessary.

Amendment of registration

57 ter. The law should provide that a registration may be amended at any time. An amendment takes effect only from the time when the information is entered into the registry record so as to be disclosed on a search of the registry record.

[Note to the Working Group: The Working Group may wish to note, in line with recommendation 56 bis which provides that a registration becomes effective when the information entered into the record can be disclosed on a search, recommendation 57 ter provides that an amendment takes effect when it can be disclosed on a search. The Working Group may also wish to note that the commentary will explain that amendment may involve various changes, such as: (i) adding or deleting items or kinds of encumbered assets; (ii) adding or deleting the name of a grantor; (iii) recording a change in the name of a grantor or secured creditor; (iv) disclosing an assignment of the security right by the secured creditor named in the original registration to a new secured creditor; or (v) disclosing a subordination agreement or undertaking that affects a registered security right.]