



General Assembly

Distr.: Limited
5 December 2005*

Original: English

**United Nations Commission
on International Trade Law**
Working Group VI (Security Interests)
Ninth session
New York, 30 January-3 February 2006

Security Interests

Recommendations of the draft Legislative Guide on Secured Transactions

Note by the Secretariat

Addendum

Contents

	<i>Recommendations</i>	<i>Page</i>
VI. Priority of the security right over the rights of competing claimants	58-85	2

* 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.



VI. Priority of the security right over the rights of competing claimants

Purpose

The purpose of the provisions of the law on priority is to establish clear and precise rules for ranking security rights in encumbered assets relative to the rights of competing claimants and to encourage the extension of secured credit by:

(a) Enabling a potential secured creditor to determine, in an efficient manner and with a high degree of certainty prior to extending credit, the priority that its security right would have over the rights of competing claimants; and

(b) Facilitating transactions by which a grantor may create more than one security right in the same asset and thereby use the full value of its assets to obtain credit.

Scope of priority rules

58. The law should have a complete set of priority rules covering priority conflicts with every possible competing claimant.

Secured obligations affected

59. The law should provide that the priority accorded to a security right:

(a) Extends to all monetary and non-monetary obligations owed to the secured creditor [up to a maximum monetary amount set forth in the registered notice], including principal, costs, interest and fees, to the extent secured by the security right; and

(b) Is unaffected by the date on which an advance is made or other obligation secured by the security right is incurred (so that a security right may secure future advances or other future obligations with the same priority as advances made or other obligations incurred at the time or before the security right is made effective against third parties).

Subordination agreements

60. The law should provide that a competing claimant entitled to priority may at any time subordinate its priority unilaterally or by agreement in favour of any other existing or future competing claimant.

[Note to the Working Group: As to subordination agreements in the case of the grantor's insolvency, see recommendation J in the recommendations of this Guide on Insolvency (A/CN.9/WG.VI/WP.21/Add.3): "The insolvency law should provide that if a holder of a security right in an asset of the insolvency estate has subordinated its priority unilaterally or by agreement in favour of any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the grantor."]

Priority of security rights that are not effective against third parties

61. The law should provide that:

(a) A security right in an encumbered asset that is not effective against third parties is subordinate to a security right in the same asset that is effective against third parties, without regard to the order in which the security rights were created;

(b) Priority among security rights that are not effective against third parties is determined by the order in which they were created[; and

(c) A security right that is not effective against third parties has, [relative to the right of an unsecured claimant, the same priority status as that right] [subject to insolvency law, priority over that right]].

[Note to the Working Group: The Working Group may wish to note that: (i) recommendation 61 (a) deals with a contest of priority between a security right that is not effective against third parties and a security right that is effective against third parties, (ii) recommendation 61 (b) deals with a priority contest between two security rights that are not effective against third parties, and (iii) recommendation 61 (c), which appears within square brackets for the consideration of the Working Group, deals with a priority contest between a security right that is not effective against third parties and an unsecured claim. Recommendation 62 deals with a priority contest between a security right that is not effective against third parties and the right of a judgement creditor in the encumbered asset. Recommendation 71 deals with a priority contest between a security right that is effective against third parties and the right of a judgement creditor in the encumbered asset.]

62. The law should provide that[, except as provided in recommendation 130 bis,] a security right that is not effective against third parties is subordinate to the right of an unsecured creditor that has, under law other than this law, obtained a judgement against a grantor and has taken the steps necessary to acquire rights in encumbered assets of the grantor by reason of the judgement, and remains subordinate to the right of such unsecured creditor even if the security right is later made effective against third parties.

[Note to the Working Group: The Working Group may wish to consider whether an exception to this recommendation should be introduced for acquisition security rights that are made effective against third parties within the relevant grace period (see recommendation 130 bis in A/CN.9/WG.VI/WP.24/Add.5). Acquisition security rights that are made effective against third parties during the relevant grace period should not lose to a judgement creditor described in this recommendation whose interest in the encumbered asset arose after the creation of the security right but before it was made effective against third parties. If this were not the case, utilizing the grace period would be too risky for acquisition financiers.]

Priority of security rights that are effective against third parties

63. The law should provide that, except as provided in other recommendations in this chapter and in the chapter on acquisition financing devices, as between two security rights in the same encumbered asset that are effective against third parties, the security right that was first made effective against third parties has priority[, even if one or more of the requirements for the creation of a security right was not satisfied at that time]. A security right in assets that the grantor acquired or that were

created after the time a security right became effective against third parties has the same priority as the security right in assets that the grantor owned or that existed at the time the security right was made effective against third parties.

[Note to the Working Group: The Working Group may wish to note that the current formulation of the first sentence of recommendation 64 is based on the assumption that the words within square brackets in recommendation 35 (see A/CN.9/WG.VI/WP.24/Add.3, recommendation 35 and Note to the Working Group) will be retained and thus a security right may be made effective against third parties even before one or more of the requirements for its creation have been satisfied at that time. If the bracketed language in recommendation 35 is deleted and thus a security right cannot be made effective against third parties before it is actually created, the first sentence of recommendation 64 will need to be reformulated along the following lines:

“The law should provide that, except as provided in other recommendations in this chapter and in the chapter on acquisition financing devices, as between two security rights in the same encumbered asset that are effective against third parties, the security right with respect to which a notice has been registered in the general security rights registry or which was first made effective against third parties, whichever occurs first, has priority.”

The commentary will provide examples as to the operation of recommendations 35 and 63, including the following:

(a) Secured creditor A (SC-A) and secured creditor B (SC-B) both register notices covering the same encumbered asset. First to register has priority, regardless of the sequence of creation of the respective security rights and regardless of whether the asset belonged to the grantor or existed at the time of creation of the first security right to be created; and

(b) SC-A registers before its security right is created, subsequently SC-B's security right is created and SC-B takes possession, subsequently SC-A's security right is created. SC-A has priority, whether or not grantor owned asset or asset existed at the time of SC-A's registering, regardless of the sequence of creation of the respective security rights and regardless of whether the asset belonged to the grantor or existed at the time of creation of the first security right to be created. In both of these cases (including all variant assumptions about times of creation and times grantor acquired asset or asset was produced), SC-A wins even though at time SC-A registered the notice its security right was not yet created.

This rule serves to encourage early registration (making the registry more reliable) and because in no case did SC-B, regardless of the fact pattern, achieve its effectiveness against third parties before SC-A registered, so SC-B could always have protected itself by searching and discovering SC-A's notice.]

Priority of a security right registered in a specialised title registry or by notation on a title certificate

64. The law should provide that a security right in movable property that was made effective under recommendation 40 bis (a) and (b) [see A/CN.9/WG.VI/WP.24/Add.3] by registration of a notice with respect to the right in a specialized title registry or by notation of the security right in a title certificate has priority over

a right in the same property that was made effective against third parties by registration in the general security rights registry.

Continuity in priority when third-party effectiveness is achieved by more than one method

65. The law should provide that, if a security right is made effective against third parties by more than one method, priority dates as of the time third-party effectiveness was first achieved, provided that there was no time at which the security right was not effective against third parties.

[Note to the Working Group: The Working Group may wish to consider whether recommendation 65 should state expressly a rule that it seems to imply, namely that if there is a lapse in third-party effectiveness (such as where the registration lapses or it is made after the relevant grace period, or where possession of an encumbered asset is delivered to the secured creditor and subsequently obtained by the grantor), priority dates as of the time third-party effectiveness is re-established. Alternatively, the matter may be clarified in the commentary.]

Priority of security rights in proceeds

66. Except as provided in the recommendations of this chapter, the law should provide that a security right in the proceeds of an encumbered asset that is effective against third parties has the same priority as the security right in the encumbered asset.

Priority of rights of buyers, lessees and licensees of encumbered assets

67. The law should provide that the right of a buyer of goods is subject to a security right in the goods that has become effective against third parties before the sale, unless the secured creditor authorized the sale. However, a buyer of inventory, who buys encumbered inventory in the ordinary course of business of the seller (and any person whose rights to the inventory derive from the buyer), takes free of the security right [created by the seller], even if the buyer has knowledge of the existence of the security right.

68. The law should provide that a lessee of goods in the ordinary course of business of the lessor takes its rights under the lease free of a security right [created by the lessor] in the goods that is effective against third parties, even if the lessee has knowledge of the existence of the security right.

69. The law should provide that a licensee in the ordinary course of business of the licensor under a non-exclusive license takes its rights under such license free of a security right [created by the licensor] in the licensed property that is effective against third parties, even if the licensee has knowledge of the existence of the security right.

[Note to the Working Group: The Working Group may wish to note that recommendations 68, 69 and 70 are designed to protect buyers, lessees and licensees of goods against secured creditors with security rights in the goods sold, leased or licensed. If the bracketed language in these recommendations is retained, protection would be limited only against secured creditors who acquired their rights from the immediate sellers, lessors or licensors and would not apply to secured creditors who acquired their rights from other persons. A possible undesirable side effect of such an approach is that, by entrusting the encumbered assets to a seller, lessor or licensor for the purpose of procuring a sale, lease or licence of the assets free of the security right, a grantor could extinguish a security right.]

Priority of statutory (preferential) claims

70. The law should limit, both in number and amount, preferential claims that have priority over security rights that are effective against third parties, and to the extent preferential claims exist, they should be described in the law in a clear and specific way.

Priority of rights of judgement creditors

71. The law should provide that a security right that is effective against third parties has priority over the rights of an unsecured creditor, even if, at or after the time when the security right has become effective against third parties, the unsecured creditor has, under law other than this law, obtained a judgement against a grantor and taken the steps necessary to acquire rights in assets of the grantor by reason of the judgement. The priority of the security right extends to amounts advanced by the secured creditor subsequent to a specified period of days after the secured creditor acquired knowledge of the existence of the unsecured creditor's rights but does not extend to amounts advanced after the expiry of that period.

[Note to the Working Group: The Working Group may wish to consider expanding recommendations 62 and 71 to cover a creditor who obtains a right as provided in recommendations 62 and 71 by way of a provisional court order.]

Priority of rights in assets for improving and storing the assets

72. If law other than this law gives rights equivalent to security rights to a creditor that has added value to goods (e.g. by repairing them) or preserved the value of goods (e.g. by storing them), such rights should be limited to the goods whose value has been improved or preserved that are in the possession of that creditor, and should have priority over pre-existing security rights in the goods that are effective against third parties.

Priority of reclamation claims

73. If law other than this law provides that suppliers of goods have the right to reclaim the goods within a specified time after occurrence of an event specified in the sales contract, the law should provide that the right to reclaim the goods is subordinate to security rights in such goods.

[Note to the Working Group: The Working Group may wish to note that recommendation 73 creates a commercial law rule designed to accord priority to secured creditors over reclamation claims. Reclamation claims may arise in the

case of the insolvency of the buyer. If an insolvency proceeding has commenced, applicable insolvency law will determine the extent to which the secured creditors and the reclamation claimants would be stayed or their rights would otherwise be affected (see recommendations 39-51 of the UNCITRAL Insolvency Guide). However, the priority rule established by this recommendation would be unaffected by the insolvency proceeding (see A/CN.9/WG.VI/WP.21/Add.3, draft additional recommendation I).]

Priority of rights of creditors in insolvency proceedings

[Note to the Working Group: See recommendation I in the recommendations of this Guide on Insolvency (A/CN.9/WG.VI/WP.21/Add.3): “The insolvency law should specify that, if a security right is entitled to priority under law other than the insolvency law, that priority continues unimpaired in insolvency proceedings except if, pursuant to the insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to Recommendation 88 of the Insolvency Guide.”]

Asset-specific priority recommendations

Priority of security rights in negotiable instruments

74. The law should provide that a security right in a negotiable instrument that has been made effective against third parties by a method other than possession of the instrument by the secured creditor is subordinate to the rights of a buyer, another secured creditor or other transferee in a consensual transaction that either:

- (a) Qualifies as a protected holder under the law governing negotiable instruments; or
- (b) Takes possession of the negotiable instrument and gives value in good faith and without knowledge that the transfer was in violation of the rights of the holder of the security right.]

Priority of security rights in rights to drawing proceeds from independent undertakings

75. [See A/CN.9/WG.VI/WP.24/Add.2, recommendation 62.]

Priority of security rights in bank accounts

76. The law should provide that a security right in a bank account, which has been made effective against third parties by control, has priority over a security right in the bank account, which has been made effective against third parties by registration of a notice in the general security rights registry. If the secured creditor is the depositary bank, the depositary bank’s security right has priority over any other security right (including a security right made effective against third parties by a control agreement with the depositary bank even if the depositary bank’s security right is later in time).

77. The law should provide that any right of the depositary bank to recoup from or set-off against the bank account obligations owed to the depositary bank by the grantor has priority over the security right of any secured creditor other than a

secured creditor who has acquired control of the bank account by becoming the customer of the depositary bank with respect to the bank account.

78. In the case of a transfer of funds from a bank account initiated by the grantor, the law should provide that the transferee of funds takes free of a security right in the bank account, unless the transferee acts in collusion with the grantor to deprive the secured creditor of its security right in the funds. This recommendation does not lessen the rights of holders of funds in bank accounts under law other than this law.

Priority of security rights in money

79. The law should provide that a person that obtains possession of money that is subject to a security right holds the money free of the security right, whether the money constitutes an original encumbered asset or proceeds, unless that person acts in collusion with the transferor to deprive the secured creditor of its security right in the money. This recommendation does not lessen the rights of holders of money under law other than this law.

[Note to the Working Group: The Working Group may wish to note that recommendation 79 is designed to promote the important policy of maximizing the negotiability of money, limiting negotiability only to the extent necessary to protect the holder of a security right in the money against collusion by a transferee of money and its transferor. It is intended that this recommendation be aligned with recommendation 78 dealing with security rights in funds transferred from a bank account.]

Priority of security rights in negotiable documents and goods covered by negotiable documents

80. The law should provide that, while goods are in the possession of a person that has issued a negotiable document with respect to them, a security right in those goods that became effective against third parties as a result of the security right in the negotiable document becoming effective against third parties has priority over another security right in the goods that was made effective against third parties by a different method while the goods were covered by the document of title.

81. The law should provide that a security right in a negotiable document and the goods covered thereby is subject to the rights under the law governing negotiable documents of a person to whom the negotiable document has been duly negotiated.

Priority of security rights in fixtures

82. The law should provide that a secured creditor with a security right in fixtures in immovables that has been made effective against third parties under real property law has priority over a secured creditor with a security right in those fixtures that has been made effective against third parties by one of the methods referred to in recommendation 35.

83. [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 was registered subsequently.]

[Note to the Working Group: The Working Group may wish to consider recommendation 83 with the relevant recommendation in the Chapter on acquisition financing devices (see A/CN.9/WG.VI/WP.24/Add.5, recommendation 130 ter.)]

84. The law should provide that the priority of security rights in fixtures in movables is governed by the general rules applicable to movable property.

Priority of security rights in masses of goods or products

85. The law should set forth rules that are consistent with the priority recommendations in this chapter and respect the priority of security rights in:

- (a) Fixtures in movables over rights of competing claimants in the asset to which the fixture is attached; and
 - (b) A product or mass of goods over the rights of competing claimants in the assets from which the product or the mass results.
-