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Recommendations of the draft Legislative Guide on Secured Transactions

Note by the Secretariat*

Addendum

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* This document is submitted 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

Consistent with the purpose of the Guide to encourage the extension of secured credit, the purpose of the provisions of the law on priority is to:

(a) Enable 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) Facilitate 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

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

Scope of priority

62. The law should provide that the priority accorded to a security right extends to all monetary and non-monetary obligations owed to the secured creditor [up to a maximum monetary amount set forth in the notice], including principal, costs, interest and fees, to the extent secured by the security right.

Priority of security rights securing future obligations

62 bis. [Subject to recommendation 71,] the priority of a security right does not depend on the date when the secured obligation was incurred.

[Note to the Working Group: The Working Group may wish to note that the commentary will clarify that if a security right securing a credit facility is made effective against third parties on day 1 and credit is extended on day 2 and then on day 3 and 4, priority dates back from the time the security right was made effective against third parties (i.e. day 1). The commentary will also explain that an exception to this rule is stated in rec. 71, which provides that, if the secured obligation was incurred after a judgement creditor acquires rights in the encumbered asset, the security right is subordinate to the rights of the judgement creditor. The Working Group may wish to consider whether further exceptions should be introduced (e.g. the super-priority of an acquisition security right should be limited to secured obligations incurred up to the time of the acquisition of the relevant assets by the transferee).]

Priority of security rights in future assets

62 ter. A security right in assets that the grantor acquired or that were created after the time a security right in them became effective against third parties [by registration] has the same priority as the security right in assets in which the grantor had rights at the time the security right was made effective against third parties.

[Note to the Working Group: The Working Group may wish to consider whether the priority in future assets should be the same as the priority in present assets only if a security right was made effective against third parties by registration. Such an approach could be justified, since only in the case of registration would third parties have notice of the possible existence of a security right.]

Subordination agreements

63. 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: The Working Group may wish to note that the commentary will make clear that, under recommendation 63, a subordination agreement would be possible not only between competing claimants with a different priority ranking but also between competing claimants with the same priority ranking (see A/CN.9/593, para. 61). The Working Group may also wish to note that subordination agreements in the case of the grantor's insolvency are addressed in 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 between security rights in the same encumbered assets

64. The law should provide that, except as provided in other recommendations in this chapter and in the chapter on acquisition financing devices, a security right in movable property registered as provided in recommendation 40 or 54 [see A/CN.9/WG.VI/WP.26/Add.5] or made effective against third parties as provided in recommendation 35 or 36 [see A/CN.9/WG.VI/WP.26/Add.5], whichever occurs first, has priority over a security right in the same property which was subsequently registered, as provided in recommendation 40 or 54, or made effective against third parties, as provided in recommendation 35 or 36.

[Note to the Working Group: The Working Group may wish to note that the commentary will make clear that issues of priority arise where there are competing rights in the same assets, the debtor defaults on the secured obligation and the value of the encumbered assets is not sufficient to satisfy all secured obligations. The commentary will also make clear that:

(a) As between two security rights registered in the general security rights registry, the first registered wins;

(b) As between two security rights registered in a specialized registry or noted on a title certificate, the first registered wins (the same rule is restated within square brackets in recommendation 65);

(c) As between a security right registered in the general security rights registry and a security right registered in a specialized registry or noted on a title certificate, the latter wins (as a result of rec. 65); and

(d) *As between a security right registered (in advance of creation) in the general security rights registry or in a specialized registry or noted on a title certificate and a security right (created and) made effective against third parties, the first registered or made effective against third parties wins.*

In addition, the Working Group may wish to note that the commentary will also clarify that, if a security right is not effective against third parties, no issue of priority arises and, therefore, such security rights have the same ranking. The commentary will also explain that recommendation 64 applies to a conflict between two security rights in the same encumbered assets (as to whether it should apply to conflicts with a buyers and judgement creditor, see note after rec. 68 bis).

Moreover, the Working Group may wish to note that the commentary will also explain that the reasons why a security right registered in advance of its creation is given priority as of the time of registration are to encourage advance registration (which provides notice to third parties) and to provide certainty to secured creditors by enabling them to determine the priority of their security rights before they extend credit. This reason does not apply to advance possession. Furthermore, such a rule would not be necessary with respect to negotiable instruments and negotiable documents, since possession of them gives a superior right than is afforded by registration (see A/CN.9/WG.VI/WP.26/Add.2, rec. 74, and A/CN.9/WG.VI/WP.26/Add.3, recs. 80 and 81). As to other tangibles, the assumption is that advance possession is not practiced (delivery of possession will always be based on an agreement about the security right). Accordingly, no general rule along the lines of recommendation 64 is introduced with respect to advance possession. The Working Group may wish to consider whether there are substantial financing practices in which the secured creditor may take possession of the encumbered assets in advance of such agreement and, if so, whether the secured creditor that took advance possession should have priority as of that time (see A/CN.9/593, para. 68).]

Priority of security or other rights registered in a specialized registry or noted on a title certificate

65. The law should provide that a security right in movable property that was made effective against third parties as provided in recommendation 40 [see A/CN.9/WG.VI/WP.26/Add.5] has priority over [(i)] a security right in the same property with respect to which a notice was registered in the general security rights registry or which was made effective against third parties by any other method regardless of the order[, (ii) a security that was subsequently registered in the specialized registry or noted on a title certificate].

[Note to the Working Group: The Working Group may wish to note that recommendation 65 does not apply to the priority of security rights in attachments. Recommendations 82 and 83 apply to attachments to immovable property, recommendation 84 applies to attachments to movables subject to a specialized registration system and recommendation 84 bis applies to attachments to movables.]

Continuity in priority

66. The law should provide that the priority of a security right is continuous notwithstanding a change in the method by which it is made effective against third

parties, provided that there is no time when the security right is not effective against third parties.

66 bis. The law should provide that, if a security right has been registered as provided in recommendations 35 and 54 or made effective against third parties as provided in recommendations 35 or 36 and subsequently there is a period at which the security right is neither registered nor effective against third parties, the priority of that security right dates from the earliest time thereafter at which the security right is either registered or made effective against third parties.

[Note to the Working Group: The Working Group may wish to note that, under recommendations 38 bis and ter (see A/CN.9/WG.VI/WP.26/Add.5), third-party effectiveness is continuous, if it lapses, it dates back from the time it was re-established (see also examples set forth in the note to rec. 38 ter).]

Priority of security rights in proceeds

67. *[See A/CN.9/WG.VI/WP.26/Add.4, rec. 67.]*

Rights of buyers, lessees and licensees of encumbered assets

68. The law should provide that, once a security right is made effective against third parties, the security right continues in the encumbered assets in the hands of a third party except as otherwise specifically provided in recommendations 68 bis, 69 and 69 bis.

[Note to the Working Group: The Working Group may wish to note that recommendation 68 is designed to state the rule that the secured creditor may follow the asset in the hands of a transferee (droit de suite, a rule stated somewhat differently in rec. 34 quater) (see A/CN.9/WG.VI/WP.26/Add.5).]

68 bis. The law should provide that a security right that was made effective against third parties before a sale, lease, licence or other disposition of the encumbered assets does not continue in the assets if the grantor transfers, leases or licences the assets free of the security right with the authority of the secured creditor.

[Note to the Working Group: The Working Group may wish to note that, under recommendation 64, registration of a notice before the creation of a security right gives priority over another security right that was (created and) made effective against third parties later. The Working Group may wish to consider whether this recommendation should apply to priority conflicts between a secured creditor and a buyer, lessees or licensee of encumbered assets acquiring a right in the assets after registration of a notice but before actual creation of a security right in them. It may be considered that the buyer, lessee or licensee should take free of the security right in these circumstances on the basis that by the time the security right is created, the encumbered assets are no longer owned by the seller or are subject to the possession or use rights of the lessee or licensee. The disadvantage of such an approach would be that the secured creditor would then be able to rely on its act of advance registration to preserve priority only as against other secured creditors. As against intervening transferees, the secured creditor would have to undertake further inquiries before being able to safely advance credit once the security right comes into existence.]

A similar issue arises when a judgement creditor acquires rights in the encumbered assets after advance notice of a security right is registered but before the security right is actually created. The considerations are somewhat different in this case since a secured creditor is not subordinated to the rights of the judgement creditor; under the recommendations in this chapter, until it acquires actual knowledge of the judgement creditor's rights and is then subordinated for advances made after receiving knowledge. Consequently, if the security right has not yet been created when the judgement creditor advises the secured creditor of its intervening rights, the secured creditor can protect itself either by requiring the grantor to discharge the judgement or by reducing the credit the secured creditor plans to extend. A similar rule could be adopted for intervening buyers. Under this approach, a buyer, licensee, or lessor of assets would take free of a prior-registered security right that has not yet come into existence provided the secured creditor had knowledge of the sale, lease or licence. Buyers, lessees, and licensees could then protect themselves by giving notice of their transaction rather than having to secure a positive waiver of priority from the secured creditor. The secured creditor would likewise be protected because it would have actual knowledge of the intervening transaction before entering into the security agreement.

The Working Group may also wish to note that application of the rule in recommendation 68 bis requires a comparison of the date at which a security right was made effective against third parties with the date of the sale, lease or license of the encumbered asset. While the date at which the security right was made effective against third parties will usually be obvious (inasmuch as the registry's records will reveal when a notice was filed), it may not be clear when a sale has taken place. For example, a contract to sell goods that are encumbered assets may be entered into between the grantor/seller and the buyer on date 1, they may have been shipped to the buyer on date 2 (either because the contract provided for shipment on that date or otherwise), the goods may have been received by the buyer on date 3, and the buyer may have paid for them on date 4; under applicable law, the sale by the grantor/seller to the buyer may have occurred on any of those dates or on still another date. Application of the rule in recommendation 68 requires knowing which of those dates is the date on which the sale took place because the date that the security right was made effective against third parties might precede some but not all of those dates. The Working Group may thus wish to consider whether recommendation 68 bis (or the commentary accompanying it) should provide additional guidance as to when a sale should be considered to have taken place for purposes of determining the status of the buyer's rights to the goods as against the secured creditor. The commentary will also make clear that, if the grantor of an asset sells it with a retention of title (ROT), the buyer takes free of the ROT when it pays the price. Before that, the ROT seller has the rights of an owner (or secured creditor, depending on whether a unitary or a non-unitary approach is followed (see A/CN.9/WG.VI/WP.24/Add.5).]

69. The law should also provide that:

(a) A buyer of inventory, who buys encumbered inventory in the ordinary course of business of the seller, takes the inventory free of the security right, even if the buyer has knowledge of the existence of the security right;

(b) A lessee of movable property in the ordinary course of business of the lessor takes its rights under the lease free of a security right in that property, even if the lessee has knowledge of the existence of the security right; and

(c) 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 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 also recommend that buyers of consumer goods [of low value] that have no knowledge of a security right in the goods should take free of a security right in the goods. In that connection, the Working Group may wish to take into account that such buyer would have no way of finding out about the existence of a security right in the goods as, under recommendations 36 (b) (see A/CN.9/WG.VI/WP.26/Add.5) and 128 (see A/CN.9/WG.VI/WP.24/Add.5) non-acquisition security rights in low-value consumer goods and acquisition security rights in consumer goods are exempted from registration (see A/CN.9/593, para. 77).]

69 bis. The law should provide that where a person acquires a right in encumbered assets free of a security right, any person who subsequently acquires a right in those assets from that person also takes free of the security right.

Priority of preferential claims

70. The law should limit, both in number and amount, preferential claims arising by operation of law that have priority over security rights, and to the extent preferential claims exist, they should be described in the law in a clear and specific way.

[Note to the Working Group: The Working Group may wish to consider whether buyers, lessees and licensees should take free of any preferential claims. As this question does not involve a priority conflict with a security right, it may be addressed in the commentary.]

Priority of rights of judgement creditors

71. The law should provide that[, except as provided in recommendation 130 bis,] a security right has priority over the rights of an enforcing unsecured creditor, provided that it was made effective against third parties before the enforcing unsecured creditor[, under law other than this law,] obtained a judgement or provisional court order against the grantor and taken the steps necessary to acquire rights in assets of the grantor by reason of the judgement or provisional court order. The priority of the security right extends to credit extended by the secured creditor within a specified period of days after the secured creditor acquired knowledge of the existence of the enforcing unsecured creditor's rights in the assets but does not extend to credit extended after the expiry of that period.

[Note to the Working Group: The Working Group may wish to consider: (i) whether it is possible for a security right in a particular asset to become effective against third parties at the same time that an unsecured creditor acquires, by reason of judgement or provisional court order, a right in that asset and (ii) if so, which of those rights has priority over the other.]

The problem is most important in the case of a security right in future assets of a grantor. The Working Group may wish to consider the following example. A secured creditor takes a security right in all present and future assets of the grantor and advances credit to the grantor. The secured creditor registers a notice that covers present and future assets. Subsequently, under law other than the secured transactions law, an unsecured creditor of the grantor obtains a judgement or provisional court order entitling the unsecured creditor to a right in the grantor's present and future assets. Still later, the grantor buys and receives delivery of new assets. At that moment, the grantor acquires rights in those assets and the security right in those assets is created and, because of the earlier registration of the notice, the security right is immediately effective against third parties. At the same time, the unsecured creditor obtains a right in those goods because of the previously granted judgement or provisional court order providing for such a right. The current draft of recommendation 71 provides that the unsecured creditor's right has priority over the security right of the secured creditor.

The Working Group may wish to consider whether in such cases the secured creditor should have priority rather than the unsecured creditor. This result would seem to further the goals of the Guide in creating greater certainty for the secured creditor with a view to making more credit available at lower cost. The result could be easily accomplished, without extensive redrafting, by adding in the first sentence of recommendation 71 the words "at the same time as or" immediately prior to the words "before the enforcing unsecured creditor".

The Working Group may also 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 right 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.

In addition, the Working Group may wish to note that the commentary will explain that the priority under recommendation 71 does not extend to credit committed but not extended before the judgement creditor took the necessary steps to acquire rights in the encumbered assets. This approach is based on the assumption that the judgement will be an event of default under the credit facility enabling the secured creditor to cease extending any credit.

The commentary will also explain the implications of this recommendations for certain practices in which the credit facility does not provide for an event of default, such as a commitment consisting of an independent undertaking where the issuer may not revoke the independent undertaking if it does not permit revocation as a result of a judgement against assets securing the grantor's obligation to reimburse the issuer for a payment under the independent undertaking.

Furthermore, the commentary will explain that, if the priority were to be limited to an amount mentioned in the notice registered, the issue might be resolved since the remaining assets of the secured creditor would be available for the payment of claims of unsecured creditors (see A/CN.9/593, para. 80-82). The

commentary will also give guidance as to the length of the time period referred to in this recommendation.]

Priority of rights in assets for improving, storing or transporting 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 or transporting them), such rights are limited to the goods, whose value has been improved or preserved and which are in the possession of that creditor, up to the value so added or preserved, and have priority over pre-existing security rights in the goods.

[Note to the Working Group: The Working Group may wish to note that limiting the priority given to storage and repair claims over security rights by reference to the extent to which they add to or preserve the value of the encumbered assets may give rise to a difficult and costly evidentiary burden for repairers, storer or transporters. The Working Group may wish to consider referring instead to the value (or the reasonable value) of the repair, transport or storage services rendered in respect of the encumbered assets. Alternatively, reference could be made to the reasonable expenses of the repairer, storer or transporter. These formulations would still ensure that the priority of the repairer, storer or transporter is limited to services rendered with respect to the encumbered assets while avoiding difficult questions of proof as to the relative value of the encumbered assets before and after the services are rendered.]

Priority of reclamation claims

73. If law other than this law provides that suppliers of goods have the right to reclaim the goods, 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 the commentary will explain that recommendation 73 creates a commercial law rule designed to accord priority to secured creditors over reclamation claims. Reclamation claims may arise by operation of law upon default or financial insolvency of the grantor. 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). The commentary will also explain, for the benefit of States that do adopt a non-unitary approach, that the reclamation claim does not include retention of title.]

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.”]

Priority of security rights in negotiable instruments

74. [See A/CN.9/WG.VI/WP.26/Add.2, rec. 74.]

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. [See A/CN.9/WG.VI/WP.26/Add.1, rec. 76.]

77. [See A/CN.9/WG.VI/WP.26/Add.1, rec. 77.]

78. [See A/CN.9/WG.VI/WP.26/Add.1, rec. 78.]

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 takes 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 the commentary will explain 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.

The Working Group may also wish to note that the commentary will clarify that the term “money” in the Guide is intended to refer to, and only to, legal tender, i.e. the currency currently in use as a medium of exchange authorized by a government. Other forms of property are casually spoken of as money, but they are not money for purposes of the Guide. For example, if one deposits currency into one’s bank account, reference is often made to money in the bank (or cash in the bank), but the depositor’s asset is no longer money, it is instead, under the Guide, “funds credited to a bank account”. and the claim of the depositor against the bank is referred to in the Guide as the “right to payment of funds credited to a bank account”. Similarly, the deposit of a check would result in the depositor’s asset no longer being a negotiable instrument, but instead would be funds credited to a bank account. In addition, money held by a coin dealer as part of a collection is not “money” under the Guide.

The Guide addresses security rights in money both as original encumbered assets and as proceeds of another form of encumbered asset. An example of the latter case would be the receipt, by a seller that has granted a security right in its

receivables, of payment of its outstanding invoices in currency (not by check or electronic funds transfer). Under the Guide, the money in the seller's hands would be the proceeds of the seller's receivable and the secured creditor would have a security right in the money as proceeds. Similarly, if a person that has granted a security right in an item of equipment sells it to a person who pays for it in cash, the money in the seller's hands constitutes proceeds of the equipment and is subject to the security right.

Like money, funds credited to a bank account may be the subject of security rights either as original encumbered assets or as proceeds. If the currency and the checks were subject to a security right in favour of the depositor's creditor, the funds credited to the bank account would in both cases be the proceeds of the pre-existing encumbered asset (the money or the negotiable instrument). If the credit to the depositor's bank account results from an electronic funds transfer from a third party in payment of a receivable owed by the transmitter to the depositor, the funds credited to the bank account would be the proceeds of the pre-existing encumbered asset (the receivable).

Each provision of the Guide, e.g. rules for creation, effectiveness against third parties, priority, etc., applies to all encumbered assets—except to the extent a special rule is provided for a particular type of asset. Thus, it is always necessary to ascertain whether a special rule exists with respect to money or the right to payment of funds credited to a bank account.

An important example of a special rule is that which governs the rights of a transferee of (i) money that, in the hands of transferor, was subject to a security right, and (ii) funds that were transferred from a bank account in which those funds, while owned by the transferor and credited to that bank account, were subject to a security right. Because of the need to preserve the negotiability of money and funds transferred from bank accounts, special rules are provided in the Guide to protect transferees of such assets.

With respect to money and funds credited to a bank account, it is important to focus on whether the issue under consideration concerns (i) those two assets as property of the grantor or (ii) the rights of third-party transferees from the grantor of money or of funds transferred from the grantor's bank account. The preceding paragraph, which deals with the rule that governs the rights of transferees (the second category), illustrates this distinction. It is separate from the rule (the first category) that governs a priority contest between a security right in money or in funds credited to a bank account vis-à-vis a competing claimant when the grantor still owns (i.e., has not transferred) the encumbered asset.]

Priority of security rights in negotiable documents

80. [See A/CN.9/WG.VI/WP.26/Add.3, rec. 80.]

81. [See A/CN.9/WG.VI/WP.26/Add.3, rec. 81.]

Priority of security rights in attachments to immovable property

82. [See A/CN.9/WG.VI/WP.26/Add.4, rec. 82.]

83. [See A/CN.9/WG.VI/WP.26/Add.4, rec. 83.]

Priority of security rights in attachments to movable property subject to a specialized registration or title certificate system

84. [See A/CN.9/WG.VI/WP.26/Add.4, rec. 84.]

84 bis. [See A/CN.9/WG.VI/WP.26/Add.4, rec. 84 bis.]

Priority of security rights in masses of goods or products

85. [See A/CN.9/WG.VI/WP.26/Add.4, rec. 85.]

85 bis. [See A/CN.9/WG.VI/WP.26/Add.4, rec. 85 bis.]

85 ter. [See A/CN.9/WG.VI/WP.26/Add.4, rec. 85 ter.]
