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Security Interests

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.



Recommendations of the draft Legislative Guide on Secured Transactions

I. Key objectives

Purpose

The purpose of the recommendations on key objectives is to provide a broad policy framework for the establishment and development of an effective and efficient secured transactions law. These recommendations could be included in a preamble of the secured transactions law as a guide to the underlying legislative policies to be taken into account in the interpretation of the law (hereinafter referred to as “the law”).

Key objectives

1. The following key objectives should be considered:
 - (a) Promote secured credit;
 - (b) Allow utilization of the full value inherent in assets to support credit in a broad array of credit transactions;
 - (c) Enable parties to obtain security rights in a simple and efficient manner;
 - (d) Recognize party autonomy;
 - (e) Provide for equal treatment of diverse sources of credit;
 - (f) Validate non-possessory security rights;
 - (g) Encourage responsible behaviour on the part of all parties by enhancing predictability and transparency;
 - (h) Establish clear and predictable priority rules;
 - (i) Facilitate enforcement of creditor’s rights in a predictable and efficient manner;
 - (j) Balance the interests of affected persons; and
 - (k) Harmonize secured transactions laws, including conflict-of-laws rules.

II. Scope of application

Purpose

The purpose of the scope provisions of the law is to specify the parties, the security rights, the secured obligations and the assets to which the law applies.

Parties, security rights, secured obligations and assets covered

2. The law should apply to all parties and types of security rights, secured obligations and encumbered assets. Any exceptions should be limited and clearly stated in the law.

3. In particular, the law should provide that it applies to:

(a) Legal and natural persons, including consumers, without, however, affecting their rights under consumer-protection legislation;

(b) Property rights created contractually to secure all types of obligations, including future obligations, fluctuating obligations and obligations described in a generic way;

(c) Possessory and non-possessory security rights in movable property and attachments securing payment or other performance of one or more obligations, present or future, determined or determinable;

(d) All types of movable property and attachments, tangible or intangible, present or future, not specifically excluded in the law, including inventory, equipment and other goods, receivables, negotiable instruments, negotiable documents, funds credited to bank accounts, rights to drawing proceeds from an independent undertaking and intellectual property rights;

[Note to the Working Group: The Working Group may wish to consider the terms “independent-undertaking-proceeds-rights” and “bank-account-rights” instead of the terms used presently throughout the draft Guide. The term “independent-undertaking-proceeds-rights” reflects that the encumbered asset is not the right to demand payment under an independent undertaking or the proceeds themselves, and is shorter than the term currently used. Similarly, the term “bank-account-rights” reflects that the encumbered asset is not the bank-customer relationship.]

(e) Security rights acquired by way of transfer of title and all other types of rights securing the payment or other performance of one or more obligations, irrespective of the form of the relevant transaction and whether ownership of the encumbered assets is held by the secured creditor or the grantor, including the various forms of retention of title, financial leases and hire-purchase agreements;

(f) Generally, outright transfers of receivables;

[Note to the Working Group: The Working Group may wish to note that the definition of “receivable” in para. 21 (o) of A/CN.9/WG.VI/WP.22/Add.1 excludes rights to payment under a negotiable instrument, the obligation to pay under an independent undertaking and the obligation of a bank to pay funds credited to a bank account. As a result, recommendation 3 (f) does not apply to an outright transfer of a negotiable instrument, an independent undertaking or a right to payment of funds credited to a bank account. However, the recommendations apply to transfers of such assets for security purposes, as they are treated as secured transactions. For example, the transfer for security purposes of a right to payment of funds in a bank account is covered as a method of achieving control (see definition of “control” in A/CN.9/WG.VI/WP.26/Add.1). As to the question whether outright transfers of negotiable instruments should be included within the scope of the draft Guide, see note after rec. 3 (f) in document A/CN.9/WG.VI/WP.26.]

(g) [Types of asset that are subject to a special registration or title certificate system as well as other methods of third-party effectiveness subject to special laws (such as a book entry or a control agreement), including securities, immovable property,] aircraft, ships and attachments thereto to the extent that the

recommendations of this law are not inconsistent with existing special laws or international obligations of the State relating to these types of asset. Where a direct inconsistency exists, the State's secured transactions law should expressly confirm that the other law and international obligations govern those assets to the extent of that inconsistency;

[Note to the Working Group: The Working Group may wish to note that securities and immovable property are excluded from the scope of the draft Guide as original encumbered assets (see rec. 4 (a) and (b) below). However, they may be affected by the recommendations of the draft Guide in two instances.

First, if a security right in securities or a mortgage secures a receivable, negotiable instrument or other obligation and the receivable is assigned, the security right in the securities or the mortgage follows. This rule does not affect any third-party rights, priority or enforcement requirements existing under securities or immovable property law (see rec. 16 in A/CN.9/WG.VI/WP.26, rec. 16). For example, a security right in intermediated securities that was made effective against third parties by a book entry or a control under securities law will have priority. This is the result under art. 5 (3) and 10 (1) of the draft UNIDROIT Convention on Substantive Rules regarding Intermediated Securities (see Study LXXVIII-Doc. 42, March 2006).

In addition, securities and immovable property may be affected by the recommendations of the draft Guide if they constitute proceeds of an asset covered in the draft Guide (e.g. inventory or funds in a bank account). The security right in the original encumbered assets continues in the proceeds (see A/CN.9/WG.VI/WP.26/Add.4, recs. 29 and 30). Whether a separate act is necessary for the security right in the proceeds to be effective against third parties is still an open issue (see A/CN.9/WG.VI/WP.26/Add.4, recs. 41 and 41 bis). However, if the proceeds are a kind of asset that is not covered by the recommendations in the draft Guide, a separate act may be necessary under other law irrespective of the outcome of the debate with respect to recs. 41 and 41 bis.

In order to better reflect the fact that securities and immovable property may be affected by the Guide, the Working Group may wish to consider whether a qualified exclusion along the lines of the text in square brackets in recommendation 3 (g) would be more appropriate than an outright exclusion along the lines of recommendation 4 (a) and (b).

If the Working Group were to adopt this approach, recommendation 40 might need to be expanded to preserve other methods of third-party effectiveness beyond registration in a specialized registry or notation on a title certificate (e.g. a book entry or a control agreement) and a new recommendation along the lines of recommendations 83 and 85 may need to be added to preserve the priority of rights made effective against third parties through one of these special methods.

Such an approach would be consistent with the approach followed in the draft Guide with respect to attachments to immovable property or movable property subject to a specialized registration or title certificate system (see A/CN.9/WG.VI/WP.26/Add.4, recs. 46, 46 bis, 82, 83, 84 and 84 bis), according to which, a security right in attachments to immovable property is subordinate to a security right in the relevant immovable property or in the relevant movable property subject to a specialized registration or title certificate system, unless it is

registered first in the immovable registry or in the specialized registry or is noted on the relevant title certificate respectively.

In addition, this approach would be consistent with the draft UNIDROIT Convention. Article 10 (1) of this draft Convention provides that a security right in securities (as original encumbered assets or as proceeds) that was made effective against third parties under the draft Convention has priority over a security right that was made effective against third parties under law outside the draft Convention (e.g. a law based on the recommendations of the draft Guide). The rationale underlying this approach is that the book-entry- or control-related system established by the draft Convention could not be relied upon if a security right in intermediated securities created and perfected under other law had priority over a Convention security right.

Moreover, this approach would avoid excluding from the scope of the draft Guide directly-held securities to the extent they are not subject to any special legislation (even the UNIDROIT draft Convention does not apply to directly-held securities). Thus, no gap would be left with respect to, for example, security rights in shares of a subsidiary all held by the parent company, since such security rights are involved in many commercial loan transactions.

On another matter, the draft Guide deals with security rights in rights to drawing proceeds under an independent undertaking but not with security rights in independent undertakings. The Working Group may wish to consider whether this fact should be explicitly stated in the recommendations. This could be done by way of a qualified exclusion in recommendation 3 (g) along the lines “and independent undertakings to the extent that the recommendations in this law are not inconsistent with special law and practice”. In any case, the commentary should explain that, if an asset otherwise outside the scope of the recommendations of the draft Guide becomes subject to these recommendations because it constitutes proceeds of an asset within the scope of the draft Guide or secures payment or other performance of a receivable, negotiable instrument or other obligation within the scope of the draft Guide, the creation, third-party effectiveness and conflict-of-laws relating to these issues are governed by the recommendations of the draft Guide, while third-party rights, priority, enforcement and conflict-of-laws relating to those issues remain subject to law outside the draft Guide.

If the Working Group decides to retain the outright exclusions of security rights in securities (or indirectly-held securities) and immovable property, and to add to the list in rec. 4 independent undertakings, instead of the qualified exclusions suggested above, it may wish to consider including the text suggested in the last sentence of the preceding paragraph in a recommendation.]

(h) Intellectual property rights to the extent that the recommendations of this law are not inconsistent with existing laws or international obligations of the State relating to these assets. A State enacting secured transactions legislation in accordance with this Guide should consider whether it might be appropriate to adjust certain of the recommendations as they apply to security rights in intellectual property. In this regard, a State should examine its existing intellectual property laws and the State’s obligations under intellectual property treaties, conventions and other international agreements and, in the event that the recommendations of the Guide are directly inconsistent with any such existing laws or obligations, the

State's secured transactions law should expressly confirm that those existing intellectual property laws and obligations govern such issues to the extent of the inconsistency. In considering whether any adjustments of the recommendations as they apply to security rights in intellectual property are appropriate, a State should analyse each circumstance on an issue-by-issue basis and should have proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with international conventions and national laws.

4. [Except to the limited extent provided in recommendations 16 and 37 relating to a personal or property right that secures a receivable, negotiable instrument or other obligation that is within the scope of the Guide,] the law should not apply to security rights in:

- (a) Securities;
- (b) Immovable property, with the exception of attachments to immovable property;
- (c) Wages;
- (d) [Assets necessary for the livelihood, basic subsistence or health of an individual or a member of his or her household].

[Note to the Working Group: With regard to the outright exclusion in recommendation 4 (d), the Working Group may also wish consider, instead of the outright exclusion, a qualified exclusion from the recommendations of the chapter on enforcement. Under such an approach, the enforcement of security rights in such assets should be subject to the same exemptions applying under general procedural law to the enforcement of rights of judgement creditors to such assets (see note after recommendation 3 (g) above and 39 bis in A/CN.9/WG.VI/WP.26/Add.5). Whether the Working Group decides in favour of a qualified or outright exclusion of securities and immovable property, the language in square brackets (see A/CN.9/603, para. 21) may be retained in recommendation 4 and perhaps added in recommendation 3 (g) as well.]

III. Basic approaches to security

Purpose

The purpose of the recommendations on basic approaches to security is to ensure that the law covers in a comprehensive and consistent manner all forms of transactions that function as security.

Comprehensive approach

5. The law should include a comprehensive and consistent set of provisions on security rights in tangibles and intangibles.

Functional approach

6. The law should treat all devices that perform security functions as secured transactions, including the transfer of title to tangibles or the outright assignment of

receivables for security purposes, retention of title sales, financial leases and hire-purchase agreements, except to the extent otherwise contemplated in recommendation 125 [see A/CN.9/WG.VI/WP.24/Add.5].

IV. Creation of the security right (effectiveness as between the parties)

Purpose

The purpose of the provisions of the law dealing with creation is to specify the way in which a security right in movable property is created (i.e. becomes effective as between the parties).

Creation of a security right by agreement

7. The law should specify that a security right is created by agreement between the grantor and the secured creditor, which is in writing [signed by the grantor in accordance with recommendation 10] [that evidences the intent of the grantor to grant a security right] or is accompanied by dispossession of the grantor pursuant to the agreement.

Minimum contents of the security agreement

8. The law should provide that the security agreement must, at a minimum, identify the secured creditor and the grantor, and reasonably describe the secured obligation and the assets to be encumbered. A generic description of the secured obligation and the encumbered assets is sufficient.

Form

9. The law should specify that a writing requirement is met by an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference (see article 6 of the UNCITRAL Model Law on Electronic Commerce).

10. [The law should also specify that, unless the law provides otherwise, where the law requires a signature of a person, that requirement is satisfied in relation to an electronic communication if:

(a) A method is used to identify that person and to indicate that person's approval of the information contained in the electronic communication message; and

(b) That method is as reliable as was appropriate for the purpose for which the electronic communication was generated or communicated, in the light of all the circumstances, including any relevant agreement (see article 7 of the UNCITRAL Model Law on Electronic Commerce).]

Assets and obligations subject to a security agreement

11. The law should specify that a security right may secure all types of obligation, including future, conditional and fluctuating obligations. It should also specify that a security right may be given in all types of asset, including parts of assets and

undivided interests in assets and assets which, at the time of the security agreement, the grantor may not yet own or have the power to dispose of, or which may not yet exist, as well as in proceeds. Any exceptions to these rules should be limited and described clearly in the law.

12. The law should specify that a security right may be granted in all assets of a grantor.

[Note to the Working Group: The Working Group may wish to note that the commentary discusses an approach taken in some legal systems of preserving in the case of insolvency of the grantor of a security right in all its assets (for a discussion of all-asset security, see A/CN.9/WG.VI/WP.11/Add.2, paras. 20-25) a certain percentage of the value of the encumbered assets for unsecured creditors (see A/CN.9/WG.VI/WP.9/Add.6, paras. 33-35). However, for the reasons set forth in the commentary, the draft Guide does not recommend this approach (see A/CN.9/WG.VI/WP.26/Add.6, priority of rights of creditors in insolvency proceedings.)]

Creation of a security right in receivables

13. [For the recommendations on receivables, see A/CN.9/WG.VI/WP.26.]

Creation of a security right in a negotiable instrument

24. [For the recommendations on negotiable instruments, see A/CN.9/WG.VI/WP.26/Add.2.]

Creation of a security right in rights to drawing proceeds from independent undertakings

25. [For the recommendations on independent undertakings, see A/CN.9/WG.VI/WP.24.]

Creation of a security right in funds credited to a bank account

26. [For the recommendations on funds credited to bank accounts, see A/CN.9/WG.VI/WP.26/Add.1.]

Creation of a security right in a negotiable document

28. [For the recommendations on negotiable documents, see A/CN.9/WG.VI/WP.26/Add.3.]

Creation of a security right in proceeds

29. [For the recommendations on proceeds, see A/CN.9/WG.VI/WP.26/Add.4.]

Creation of a security right in attachments

31. [For the recommendations on attachments, see A/CN.9/WG.VI/WP.26/Add.4.]

Creation of a security right in masses of goods or products

32. [For the recommendation on masses of goods or products, see A/CN.9/WG.VI/WP.26/Add.4.]

Time of creation

33. The law should provide that, unless the parties otherwise agree, a security right becomes effective as between the parties at the time the security agreement is concluded or at the time the grantor is dispossessed, whichever occurs first.

34. The law should provide that, unless the parties otherwise agree, a security right in future property is created when the grantor acquires rights or the right to transfer rights in such property.
