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Addendum

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A. General remarks

1. The concept of priority and its importance

1. In a secured transactions regime, the term "priority" refers to the extent to which a secured or other creditor may derive the economic benefit of its right in an encumbered asset in preference to a competing claimant (for the definitions of the terms "priority" and "competing claimant", see Introduction, sect. B, Terminology and rules of interpretation, para. […]). As discussed below, only one of the competing claimants must be a secured creditor of the grantor. Any other competing claimant may be another secured creditor of the grantor or the holder of another type of proprietary right, such as the holder of a right created by statute (e.g. a preferential creditor) or by judgement (i.e. a judgement creditor), a buyer, lessee or licensee of the encumbered asset or the insolvency representative in the grantor's insolvency proceeding.

2. Issues of priority typically arise where the debtor defaults on a secured obligation and the value of the encumbered asset is not sufficient to satisfy that obligation as well as the obligations owed to other competing claimants asserting a right in the asset. In these situations, the secured transactions law must determine how the economic value of the asset is to be allocated among competing claimants. A typical example of such a case is where a grantor defaults on a loan obligation to a lender that is secured by an asset of the grantor, and the grantor has also created a security right in the same asset in favour of another lender to secure a different loan. Another example is a situation where a grantor defaults on a loan obligation to a lender that is secured by an asset of the grantor, and an unsecured creditor of the grantor has obtained a judgement against the grantor and has taken steps under applicable law to obtain a property right in the same asset by reason of the judgement.

3. In other cases, the application of priority rules will lead to a person taking the encumbered asset free of competing claims. A typical example of such a case is where a grantor creates a security right in an encumbered asset in favour of a lender and then sells the asset to a third party. In this situation, the secured transactions law must determine whether the buyer of the asset takes title to the asset free of the lender's security right. Another example is where a grantor creates a security right in an encumbered asset in favour of a lender and then leases or licenses the asset to a third party. Here, the secured transactions law must determine whether the lessee or licensee may each enjoy its proprietary rights under the lease or license unaffected by the lender's security right.

4. An essential element of an effective secured transactions regime is that security rights have priority over the rights of unsecured creditors. It is generally accepted that giving secured creditors priority over unsecured creditors is necessary to promote the availability of secured credit. Unsecured creditors can take other steps to protect their rights, such as monitoring the status of the credit, charging interest on amounts that are past due or obtaining a judgement with respect to their claims in the event of non-payment. In addition, secured credit can increase the

working capital of the grantor, which in many instances benefits the unsecured creditors by increasing the likelihood that the unsecured debt will be repaid. In fact, advances made under a secured revolving working capital loan facility are often the source from which a company will pay its unsecured creditors in the ordinary course of its business (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. […]).

5. However, in all the cases mentioned above, priority is an issue only if security rights are effective against third parties. Security rights that are not effective against third parties have the same ranking as against each other and as against the rights of competing claimants (including unsecured creditors). However, security rights that are not effective against third parties are nevertheless effective against the grantor (see A/CN.9/631, recommendation 31).

6. The concept of priority is at the core of every successful secured transactions regime and it is widely recognized that effective priority rules are necessary to promote the availability of secured credit. There are two primary reasons for this. First (as discussed in para. 7 below), to the extent that priority rules are clear and lead to predictable outcomes, prospective secured creditors are able to determine, in an efficient manner and with a high degree of certainty prior to extending credit, the priority that their security rights will have relative to the rights of competing claimants in the event that a priority dispute arises in the future. Thus, priority rules function not only to resolve disputes, but also to encourage prospective creditors to extend credit by allowing them to predict how a potential priority dispute will be resolved. In this way, the existence of effective priority rules can have a positive impact on the availability and cost of secured credit. Second (as discussed in para. 8 below), where the secured transactions regime recognizes the ability of a grantor to create more than one security right in the same encumbered asset, effective priority rules encourage prospective creditors to extend credit secured by the excess value of an asset already subject to a security right in favour of other creditors, thereby making it possible for grantors to utilize the full value of their assets to obtain more credit, which is one of the key objectives of any effective and efficient secured transactions regime (see chap. I, Key objectives, sect. B).

7. With respect to the first reason mentioned above, the most critical issue for the secured creditor is what its priority will be in the event it seeks to enforce the security right either within or outside of the grantor's insolvency, especially where the encumbered asset is expected to be the creditor's primary or only source of repayment. To the extent that the creditor has uncertainty with respect to the priority of its prospective security right at the time it is evaluating whether to extend credit, the creditor will place less reliance on the encumbered asset. This uncertainty may cause the creditor to increase the cost or reduce the amount of the credit to reflect the diminished value of the encumbered asset to the creditor, and may even cause the creditor to refuse to extend credit altogether. To minimize this uncertainty, it is important that secured transactions laws include clear priority rules that lead to predictable outcomes and also that these outcomes are respected by insolvency law to the maximum extent possible (see chap. XI, Insolvency, paras. […]).

8. With respect to the second reason mentioned above, it should be noted that priority rules have an additional positive impact on the availability of secured credit, since many banks and other financial institutions are willing to extend credit based upon security rights that do not have a first-priority ranking but are

subordinate to one or more higher-priority ranking security rights, so long as they perceive that there is value in the grantor's assets to support their security rights and can clearly establish the lower-ranking priority of their security rights. For example, in jurisdictions that recognize an all-asset security (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. […]), Lender B may be willing to extend credit to a grantor whose assets are already subject to an all-asset security in favour of Lender A, so long as Lender B believes that the value of the grantor's assets sufficiently exceeds the amount of the loan secured by the existing all-asset security to support the additional extension of credit by Lender B. This result is much more likely to occur in a jurisdiction that has clear priority rules that enable creditors to assess their priority with a high degree of certainty. By facilitating the granting of multiple security rights in the same assets, priority rules enable a grantor to maximize the extent to which it can use its assets to obtain credit.

9. Because of the importance of priority rules, a modern secured transactions regime typically incorporates a set of priority rules that are comprehensive in scope, covering a broad range of existing and future secured obligations and encumbered assets, and providing ways for resolving priority conflicts among a wide variety of competing claimants. Such rules also typically deal with the impact on priority of the method by which the security right is made effective against third parties (e.g. automatic third-party effectiveness, registration, possession or control). A secured transactions law that incorporates such precise and detailed priority rules, as opposed to a set of abstract principles that can require interpretation in particular cases, encourages prospective creditors to extend secured credit by giving them a high degree of assurance that they can predict how potential priority disputes will be resolved.

10. In view of the above, the Guide identifies a two-fold purpose of the priority provisions of a secured transactions law (see below, sect. C, Recommendations, Purpose).

11. It is important to note that no matter what priority rule is in effect in any jurisdiction, it will only have relevance to the extent that the applicable conflict-of-laws rules provide that such priority rule governs. This issue is discussed in chapter XIII, Conflict of laws (see paras. […]).

2. Approaches to determining priority

12. There are various possible approaches to determining priority. More than one of these approaches may effectively coexist in the same legal system insofar as they may apply to different types of priority conflicts. This section describes these various approaches, indicating in each case their respective advantages and disadvantages in the context of a modern secured transactions regime.

(a) Priority rules where a registration system exists

13. As discussed above, in order to promote the availability of secured credit effectively, it is important to have priority rules that permit creditors to determine their priority with the highest degree of certainty at the time they extend credit and that enable grantors to use the full value of their assets to obtain credit. As discussed in chapter V, Effectiveness of a security right against third parties, (paras. […]) and

chap. VI, The registry system, (see paras. […]), one of the most effective ways to provide for such certainty is to base priority on the use of a public registry.

14. In most jurisdictions in which there is a reliable system for registration of notices with respect to security rights, priority is determined by the order of registration of the notice, with priority being accorded to the right referred to in the earliest-registered notice (often referred to as the "first-to-register priority rule"). In some jurisdictions, this rule applies even if one or more of the requirements for the creation of a security right have not been satisfied at the time of the registration, which avoids the need for a creditor to search the registration system again after all remaining requirements for the creation of its security rights have been satisfied. This rule provides the creditor with certainty that, once it registers a notice of its security right, no other right with respect to which a notice is registered will have priority over its security right. Other existing or potential creditors are also protected because the registered notice will warn them about potential security rights and they can then take steps to protect themselves (such as by requiring personal guarantees or security rights with lower-priority ranking in the same property or higher-priority-ranking security rights in other property).

15. Notwithstanding the foregoing, some States have recognized limited exceptions to the first-to-register priority rule. For example, a security right in consumer goods is deemed to be automatically effective against third parties upon its creation. Thus, the priority of such a security right is determined on the basis of the time of its creation.

16. In other States, as long as registration occurs within a specified period of time after the creation of a security right (often referred to as a "grace period"), priority will be determined according to the order of creation rather than registration of a notice with respect to the security right. Thus, a security right that is created first but registered second, may still have priority over a security right that is created second but registered first, as long as the notice is registered within the applicable grace period.

17. Under such an approach, because of the possibility that its registered security right will become subordinate to an earlier-created security right that is registered within the applicable grace period, a prospective secured creditor can protect itself only by delaying its extension of credit to the grantor until any applicable grace period relating to other potential claims has expired. Thus, until the grace period expires, the registration date is not a reliable measure of a creditor's priority ranking and there is significant uncertainty that does not exist in legal systems in which no such grace periods exist.

18. In order to avoid undermining the certainty achieved by the first-to-register rule, some States restrict the use of grace periods to rare circumstances, such as: (a) acquisition security rights (unitary approach) or acquisition financing rights (non-unitary approach); (b) circumstances in which registration before, or concurrently with, creation is not logistically possible; or (c) circumstances in which the time difference between creation and registration cannot be minimized through the use of electronic registration or other registration techniques.

19. Many States have adopted an exception to the first-to-register priority rule for security rights in specific types of asset, such as cars and boats, which may also be registered in a specialized registry or noted on a title certificate. As a result, a

security right registered in one of those systems is often given priority over a security right with respect to which a notice was previously registered in a general security rights registry. The reason for this approach is the need to ensure that purchasers of assets that are registered in a specialized registry or noted on a title certificate can have full confidence in the records of that system in assessing the quality of the title they are acquiring.

(b) Priority based on possession or control

20. As discussed in chapters IV, Creation of a security right (effectiveness as between the parties) (see paras. […]) and V, Effectiveness of a security right against third parties (see paras. […]), possessory security rights traditionally have been an important component of the secured transactions laws of most jurisdictions. In recognition of this fact, even in certain jurisdictions that have a first-to-register priority rule, priority may also be established based on the date that the creditor obtained possession of the encumbered asset, without any requirement of a registration of a notice. In these jurisdictions, priority is often accorded to the creditor that first either registered a notice of its security right in the registration system or obtained a security right by possession.

21. Notwithstanding its importance, priority based on possession has significant disadvantages. First, it is usually commercially impractical in those situations where the grantor must maintain possession of the encumbered assets so as to use them in the operation of its business. Second, the requirement that the secured creditor maintain possession of the encumbered asset may impose undesirable administrative burdens on the creditor. Third, because possession often is not a public act, the holder of a security right made effective against third parties by possession will, under many legal regimes, have the burden of establishing precisely the time when it obtained possession.

22. Despite these disadvantages, priority based on possession is commercially useful in the case of certain types of encumbered asset, such as negotiable instruments (e.g. a cheque, bill of exchange or promissory note; see Introduction, sect. B, Terminology and rules of interpretation, para. […]) or negotiable documents of title (e.g. a bill of lading or warehouse receipt; see Introduction, sect. B, Terminology and rules of interpretation, para. […]), in which possession by the secured creditor can enable the creditor to prevent prohibited dispositions of the encumbered asset by the grantor. For these types of asset, the laws of many States provide that priority of a security right may be established either by possession or registration. In addition, a security right that becomes effective against third parties by possession is generally accorded priority over a security right made effective against third parties only by registration, even if the registration occurs first. This result is consistent with the expectations of the parties in the case of negotiable instruments and negotiable documents, because rights in such assets are traditionally transferred by possession.

23. In some States, the concept of possession has evolved into the more sophisticated concept of “control”, according to which a secured creditor may be deemed to have possession of an encumbered asset if it is able, by contract with the person holding actual possession of the asset, to control the disposition of the asset. In those States, control is recognized as a method of making a security right effective against third parties. In the case of certain types of asset, such as the

proceeds under an independent undertaking, control may be the exclusive method for achieving effectiveness against third parties. In such a case, priority is accorded to a security right in such an asset only if the secured creditor is deemed to have control with respect to the asset. In the case of other types of asset, such as the right to the payment of funds credited to a bank account, third-party effectiveness may be based on either control or registration in the general security rights registry. Here, the priority system generally awards priority to a security right made effective by control over a security right made effective by an alternative method.

(c) Alternative priority rules

24. In jurisdictions in which there is no registration system for security rights, both effectiveness of a security right against third parties and priority are often based on the time when the security right is created. In those jurisdictions, although non-possessory security rights may be permitted (often in the form of retention-of-title sales, transfers of title to tangible property or assignments of receivables for security purposes), creditors typically seek to ascertain the existence or non-existence of competing rights through representations by the grantor or information available in the market. In those jurisdictions, because there is no system to determine the priority of creditors with security rights in the same asset, it is difficult or impossible for a grantor to grant more than one security right in the same asset and thus to utilize fully the value of its assets to obtain secured credit. However, the secured obligation may be assigned (e.g. by the retention-of-title seller) together with the right securing it, but this approach often results in costs to the seller that are passed on to the end-buyer (in addition to the cost of the initial acquisition financing reflected in the price of the goods or the interest rate of the credit).

25. Some jurisdictions have adopted a special priority rule with respect to certain types of encumbered asset. For example, in some jurisdictions, effectiveness of a security right in a receivable against third parties and competing claims is based on the time that the debtor of the receivable is notified of the existence of the security right. However, this system is not conducive to the promotion of secured credit for a number of reasons. First, it does not permit the creditor to determine, with a sufficient degree of certainty at the time it extends credit, whether there are any competing security rights in the receivables. Second, the system does not provide an efficient way of obtaining security rights in future receivables because notification of the debtors of future receivables may not be possible at the time of the initial extension of credit and therefore debtors of the future receivables must be notified as the future receivables arise (except in the case of future receivables expected to arise under a long-term contract that exists at the time when credit is extended). Third, if there is a large number of debtors of receivables, notification may be costly. Fourth, many grantors may not wish to have their customers directly notified of the existence of a security right in their receivables.

3. Extent of priority

26. In order to encourage creditors to extend secured credit, it is essential that they be able to determine at the time they make a commitment to extend credit whether the priority of their security right will extend to the entire secured obligation owed to them or just to a portion of it. Specifically, they must be able to determine

whether priority will extend only to the credit they extend contemporaneously with the conclusion of the security agreement or whether it will extend to: (a) obligations that arise thereafter pursuant to the terms of the security agreement (e.g. future advances under a revolving credit agreement); or (b) contingent obligations that become actual obligations thereafter upon the occurrence of the contingency (e.g. obligations that become payable under a guaranty).

27. In some jurisdictions, the same priority is accorded to the entire secured obligation, regardless of the time when the obligation arises. Under such an approach, a security right may extend to all secured monetary and non-monetary obligations owed to the secured creditor, including principal, costs, interest and fees. Priority is unaffected by the date on which an advance or other obligation secured by the security right is made or incurred. This means that a security right may secure future advances under a credit facility with the same priority as advances made under the credit facility contemporaneously with the creation of the security right.

28. For example, in the case of a loan facility under which the lender has agreed on Day 1 to make advances to the grantor from time to time for the entire one-year term of the facility, secured by a security right in substantially all of the grantor's assets, the security right will have the same priority for all of the advances made, regardless of whether they are made on Days 1, 35, or 265.

29. In the case of credit extended for the delivery of goods or services in instalments matching deliveries of goods or services, this approach results in the entire claim being treated as coming into existence at the time when the contract is entered into and not at the time of each delivery of goods or services. The rationale for this approach is that it is the most cost-efficient approach (e.g. the secured creditor need not determine priority each time it extends credit) and minimizes the risk to the grantor that subsequent extensions of credit under the security agreement will be interrupted if the secured creditor determines that a future advance does not have priority.

30. In other jurisdictions, priority is limited in one of two ways. First, priority may be limited to the amount of debt existing at the time of the creation of a security right. The advantage of this approach is that it may (though not necessarily) match priority with the contemplation of the parties at the time of creation. The disadvantage of this approach is that it requires creditors to conduct additional due diligence (e.g. searches for new registrations) and to execute additional agreements and make additional registrations for amounts of credit extended subsequent to the time of the creation of a security right. This is particularly problematic in the case of revolving credit facilities, which represent one of the most effective means of providing secured credit, since this type of credit facility most efficiently matches the grantor's unique borrowing needs (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. […]).

31. In yet other jurisdictions, priority is limited to the maximum amount specified in the notice registered in a public registry with respect to the security right. The rationale for this approach is that it encourages subordinate financing by encouraging prospective subordinate creditors to extend credit on the "equity" in encumbered assets (e.g. the value of the encumbered assets in excess of the maximum amount secured by the higher-ranking security right referred to in the

registered notice). One argument against this approach is that it merely encourages secured creditors to inflate the amount mentioned in the registered notice to include an amount greater than that contemplated at the time of the security agreement to accommodate unanticipated future advances (see chap. VI, The registry system, paras. […]).

32. In yet other jurisdictions, priority is accorded to all amounts of credit, even if extended after the creation of the security right, and for all contingent obligations that may arise after the creation of the security right, without the need to specify a maximum amount. In such systems, a security right may extend to all secured monetary and non-monetary obligations owed to the secured creditor and secured by the security right, including principal, costs, interest and fees, as well as performance obligations and other contingent obligations. Priority is unaffected by the date on which an advance or other obligation secured by the security right is made or incurred. This means that a security right may secure future advances under a credit facility with the same priority as advances made under the credit facility contemporaneously with the creation of the security right (see A/CN.9/631, recommendations 74 and 76).

33. The Guide recommends that the priority of a security right should extend to all obligations secured under a security agreement. However, if a State determines that limiting the maximum amount of the secured obligation in the registered notice will encourage subordinate lending, priority may be limited to the maximum amount stated in the registered notice (see A/CN.9/631, recommendation 74; for the discussion of a possible limitation of priority in the case of a priority conflict with a judgement creditor, see paras. 90 and 91 below and recommendation 90).

4. Irrelevance of knowledge of the existence of the security right

34. In many legal systems, the ordering of priority according to the time of registration applies even if the creditor acquired its security right with knowledge of an existing unregistered security right. This rule is generally predicated on the premise that it is often difficult to prove that a person had knowledge of a particular fact at a particular time. This is particularly true in the case of a legal person. As a result, priority rules that are dependent on knowledge provide opportunities to subject registrations to challenge and complicate dispute resolution, thereby diminishing certainty as to the priority status of secured creditors and hence reducing the efficiency and effectiveness of the system.

5. Subordination

35. In most jurisdictions, a secured creditor may at any time subordinate, either unilaterally or by agreement, its security right to the right of an existing or future competing claimant. For example, Lender A, holding a security right in all existing and after-acquired assets of a grantor, may agree to permit the grantor to give a first-priority security right in a particular asset to Lender B so that the grantor could obtain additional financing from Lender B based on the value of that asset. The recognition of the validity of subordination of security rights reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention).

36. However, subordination cannot affect the rights of a competing claimant without its consent. Thus, for example, a subordination agreement cannot adversely affect the priority of a secured creditor that is not a party to that agreement (see A/CN.9/631, recommendation 77). Under this approach, it is essential that the priority afforded by a subordination agreement continue to apply in an insolvency proceeding of the grantor. In fact, in some jurisdictions, such a provision in the insolvency laws may be necessary to empower the courts to enforce a subordination agreement and to empower insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see chap. XI, Insolvency, para. […], and A/CN.9/631, recommendation 181).

37. Subordination of security rights and other proprietary rights in encumbered assets does not mean subordination of payments prior to default, which is a matter for contract law. Normally, prior to default and as long as the grantor services the loan or other credit received, the secured creditor is not entitled to enforce its security right and priority is not an issue. Thus, in the absence of an agreement to the contrary, a grantor is not precluded from making payments on obligations secured by subordinate security rights (as to priority in a case where a subordinate claimant receives proceeds from the collection, sale or other disposition of an encumbered receivable, see chap. X, Post-default rights, paras. […]).

6. Priority between security rights in the same encumbered assets

38. One of the cornerstones of an effective secured transactions regime is the manner in which it resolves priority disputes among competing security rights in the same encumbered assets. Such priority disputes may involve security rights that are made effective against third parties by registration, security rights that are made effective against third parties by another method, or a combination of security rights that are made effective against third parties by registration and security rights that are made effective against third parties by another method.

39. In many legal systems that have a general security rights registry, priority among security rights that were made effective against third parties by registration, subject to limited exceptions (see para. 45 below), is determined by the order in which registration occurs, regardless of the order of creation, even if one or more of the requirements for the creation of a security right were not satisfied at that time (see A/CN.9/631, recommendation 78, subpara. (a)).

40. This approach may be illustrated by the following example. A Grantor applies to Secured Creditor 1 for a loan, to be secured by a security right in all of the Grantor's existing and future equipment (a security right that may be made effective against third parties by registration of a notice in the general security rights registry). On Day 1, Secured Creditor 1 conducts a search of the registry, which confirms that no other notices have been filed with respect to security rights of other creditors in the Grantor's equipment. On Day 2, Secured Creditor 1 enters into a security agreement with the Grantor, in which Secured Creditor 1 commits to make the requested secured loan. On Day 3, Secured Creditor 1 registers a notice of the security right in the general security rights registry, but it does not make the loan to the Grantor until Day 5. Thus, the security right of Secured Creditor 1 was created and became effective against third parties on Day 5 (i.e. the first time when all of the requirements for creation and third-party effectiveness were satisfied). However, on Day 3, the Grantor enters into a security agreement with Secured Creditor 2,

providing for a loan to be made by Secured Creditor 2 to the Grantor to be secured by a security right in the Grantor's existing and future equipment, and on the same day Secured Creditor 2 registers a notice of the security right in the general security rights registry and grants the loan to the grantor. As a result, the security right of Secured Creditor 2 was created and made effective against third parties on Day 3. Under the first-to-register approach described above, Secured Creditor 1's security right would have priority over Secured Creditor 2's, regardless of the fact that Secured Creditor 2's security right was created and made effective against third parties before Secured Creditor 1's security right.

41. The primary reasons for this approach are: (a) to encourage advance registration (which provides notice to third parties); and (b) to provide certainty to secured creditors by enabling them to determine the priority of their security rights before they extend credit. In the above example, if Secured Creditor 1 searches the registry on Day 2 after it registers its notice and determines that there are no other notices in the registry that cover the relevant encumbered asset, Secured Creditor 1 can make its loan on Day 5 knowing with certainty that its security right will have priority over any other security right in the encumbered asset that may be created by the grantor in the future, because the priority of Secured Creditor 1's security right dates back to the time of its registration. By enabling Secured Creditor 1 to achieve this high level of certainty, the first-to-register approach can be a significant factor in promoting secured credit.

42. This certainty would not exist under an alternative approach, adopted in some jurisdictions, that accords priority to the first security right to become effective against third parties, since there would always be a risk that another security right could achieve third-party effectiveness, and thus priority, after Secured Creditor 1 conducts its search of the record but before it makes its loan. This risk would exist regardless of how short that time period might be.

43. In the case of a priority dispute among security rights made effective against third parties by methods other than registration, priority is normally accorded to the security right that is first made effective against third parties (see A/CN.9/631, recommendation 78, subpara. (b)). This rule would apply, for example, in a situation where one security right in a particular encumbered asset was made effective against third parties by possession and another security right in the same asset was made effective automatically upon its creation. In the case of security rights achieving third-party effectiveness by possession, there is no need for a "first-to-obtain-possession" rule analogous to the "first-to-register" rule, as typically a secured creditor would obtain possession of the encumbered asset at the same time it extends credit. In any case, such a "first-to-obtain-possession" rule would not be necessary for security rights in negotiable instruments or negotiable documents, if possession of them would give a superior right than is obtained by registration (see A/CN.9/631, recommendations 99 and 107).

44. In the case of priority disputes among security rights made effective against third parties by registration and security rights made effective against third parties by other methods, priority is accorded to the first security right to be registered or made effective against third parties, whichever occurs first (see A/CN.9/631, recommendation 78, subpara. (c)). This rule represents a logical extension of the first-to-register rule, using the registry as a basis for enabling secured creditors to achieve a high level of certainty with respect to the priority of their security rights.

The rule also encourages the use of the registry for making security rights effective against third parties.

45. As noted above (see para. 39), the priority rules discussed herein are subject to limited exceptions. These exceptions reflect special priority rules relating to certain types of transaction or encumbered asset based on special policy or practical considerations relating to such transactions or assets. These types of transaction or asset are: (a) acquisition security rights (unitary approach) or acquisition financing rights (non-unitary approach) (see A/CN.9/631, recommendations 189-195, 198 and 199, in chap XII, Acquisition financing rights, sects. A and B, respectively); (b) cases in which third-party effectiveness is achieved by registration in a specialized registry (as is often the case for ships or aircraft) or notation on a title certificate (as is often the case for automobiles) (see A/CN.9/631, recommendations 83 and 84); (c) cases in which third-party effectiveness of security rights in rights to payment of funds credited to a bank account or proceeds under an independent undertaking may be achieved by control (see A/CN.9/631, recommendations 101 and 105); (d) cases in which third-party effectiveness of security rights in negotiable instruments or negotiable documents may be achieved by possession (see A/CN.9/631, recommendations 99 and 107); (e) cases involving security rights in attachments (see A/CN.9/631, recommendations 93-95); and (f) situations involving security rights in masses of goods and products (see A/CN.9/631, recommendations 96-98).

7. Priority of a security right in after-acquired property

46. As discussed in greater detail in chapter IV, Creation of a security right (see paras. […]), in some legal systems a security right may be created in property that the grantor may acquire in the future ("after-acquired property"). Such a security right is obtained automatically at the time the grantor acquires the property without any additional steps being required at that time. As a result, the costs incidental to the creation of the security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory that is continuously being acquired for resale, receivables that are continuously being collected and regenerated (see chap. II, Scope of application and other general rules, sect. F, Examples of financing practices covered, paras. […]) and, to a lesser extent, equipment which is periodically being replaced in the normal course of the grantor's business.

47. The recognition of automatic creation of a security right in after-acquired property without additional steps being required at the time when the assets come into existence raises the question of whether the priority dates from the time when the security right is first registered or becomes effective against third parties, or from the time the grantor acquires the property. Different legal systems address this matter in different ways. The approach of some legal systems depends on the nature of the creditor competing for priority (with priority dating from the date of registration or third-party effectiveness vis-à-vis other consensual secured creditors, and from the date of acquisition by the grantor vis à vis all other creditors). It is generally accepted that dating priority from the time of registration or third-party effectiveness, rather than from the date the grantor acquires rights in the after acquired assets, is the most efficient and effective approach in terms of promoting the availability of secured credit (see, for example, art. 8, para. 2, of the United

Nations Assignment Convention). Thus, effective secured transactions regimes specify that a security right in after-acquired assets of the grantor has the same priority as a security right in assets of the grantor owned or existing at the time the security right is initially registered or made effective against third parties (see A/CN.9/631, recommendation 79).

8. Priority of a security right in proceeds

48. If a creditor has a security right in proceeds (for the definition of "proceeds", see Introduction, sect. B, Terminology and rules of interpretation, para. […]), issues will arise as to the priority of that security right as against the rights of other competing claimants. Competing claimants with respect to proceeds may include, among others, another creditor of the grantor that has a security right in the proceeds and a creditor of the grantor that has obtained a right by judgement or execution against the proceeds.

49. Property that constitutes proceeds to one secured creditor may constitute original encumbered assets to another secured creditor. For example, Creditor A may have a security right in all of the grantor's receivables by virtue of its security right in all of the grantor's existing and future inventory and the proceeds arising upon the sale or other disposition thereof, and Creditor B may have a security right in all of the grantor's existing and future receivables as original collateral. If the grantor later sells on credit inventory that is subject to the security interest of Creditor A, both creditors have a security right in the receivables generated by the sale: Creditor A has a security right in the receivables as proceeds of the encumbered inventory, and Creditor B has a security right in the receivables as original encumbered assets.

50. The priority rules may differ depending on the nature of the competing claimant. When the competing claimant is another secured creditor, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to rights in original encumbered assets. In a legal system in which the first right in particular property that is reflected in a registration has priority over the rights of a competing claimant, that same rule could be used to determine the priority when the original encumbered asset has been transferred and the secured creditor now claims a right in proceeds. If a registration was made with respect to the right in the original encumbered asset before the competing claimant made a registration with respect to the proceeds, the first security right could be given priority (see A/CN.9/631, recommendation 80).

51. In cases in which the order of priority of competing rights in the original encumbered asset is not determined by the order of registration (as is the case, for example, with acquisition financing rights that enjoy a super-priority), a separate determination will be necessary for the priority rule that would apply to proceeds (see chap. XII, Acquisition financing rights, paras. […]).

9. Continuity in priority

52. In jurisdictions in which the third-party effectiveness of a security right may be established by more than one method (e.g. automatically, by registration, by possession or by control), a question arises as to whether a secured creditor that initially established the priority of its security right by one method should be

permitted to change to another method without losing the original priority. In principle, there is no reason for a security right to lose its priority in this situation, provided there is no time during which the security right is not effective against third parties, so that the security right is subject to one method of third-party effectiveness or another at all times.

53. For example, if a security right in an asset first becomes effective by registration and the secured creditor subsequently obtains possession of the asset while the registration is still effective, the security right remains effective as against third parties and priority relates back to the time of registration. If, however, the secured creditor obtains possession of the asset after the registration has lapsed through the passage of time or otherwise, the priority of the security right dates from the time when the secured creditor obtained possession (see A/CN.9/631, recommendations 81 and 82; see also recommendations 47 and 48, which provide that third-party effectiveness is continuous and, if it lapses, it dates from the time it is re-established).

10. Priority of a security right registered in a specialized registry or noted on a title certificate

54. In many jurisdictions, a security or other right (such as the right of a buyer or lessee of an encumbered asset) may be registered in the general security rights registry or in a specialized registry, or it may be noted on a title certificate (see A/CN.9/631, recommendation 39). The question arises in this case as to which right has priority, as between the right registered in the general security rights registry and the right registered in the specialized registry or noted on a title certificate.

55. In many jurisdictions, a security right or other right registered in a specialized registry or noted on a title certificate has priority over a security right registered in a general registry (see A/CN.9/631, recommendation 83). The reason for this approach is to enable specialized registries to serve effectively their primary purpose of protecting buyers of the assets subjected to specialized registration. Under this approach, buyers of such assets can have full confidence in the completeness of the records in the system when assessing the quality of the title they are acquiring.

11. Rights of buyers, lessees and licensees of encumbered assets

(a) General

56. When a grantor sells assets that are subject to existing security rights, the buyer, lessee or licensee has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold (subject to certain exceptions; see para. 59 below). It is important that priority rules address both of these interests and that an appropriate balance be struck. If the rights of a secured creditor in particular assets are put at risk every time its grantor sells such assets, their value as security would be severely diminished and the availability of secured credit based on the value of such assets would be jeopardized.

57. The general principle is that a buyer or other transferee takes an encumbered asset subject to a security right and a lessee or licensee's rights are limited by a

security right (*droit de suite*; see chap. V, Effectiveness of a security right against third parties, paras. […]; see also A/CN.9/631, recommendations 32 and 85). In other words, the secured creditor may follow the asset in the hands of the buyer or other transferee, lessee or licensee. Exceptions to this general principle with respect to each of these three types of transaction are discussed below.

(b) Rights of buyers

58. As already mentioned (see chap. V, Effectiveness of a security right against third parties, paras. […]; and chap. IV, Creation of a security right, paras. […]), when an encumbered asset is sold, the secured creditor retains its security right in the original encumbered asset and also obtains a security right in the proceeds of the sale. In this situation, a question arises as to whether the security right in proceeds should replace the security right in the encumbered asset. It is sometimes argued that it should, on the premise that the secured creditor is not harmed by a sale of the assets free of its security right so long as it retains a security right in the proceeds of the sale. However, this would not necessarily protect the secured creditor, because proceeds are often not as valuable to the creditor as the original encumbered assets. In many instances, the proceeds may have little or no value to the creditor as security (e.g. a receivable that cannot be collected). In other instances, it might be difficult for the creditor to identify the proceeds and its claim to the proceeds may, therefore, be illusory. In addition, there is a risk that the proceeds, even if they are of value to the secured creditor, may be dissipated by the seller that receives them, leaving the creditor with nothing. Jurisdictions have taken a number of different approaches to achieving this balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession. The Guide takes the position that the secured creditor should retain its security right in the original encumbered asset and also a security right in the proceeds of its sale or other disposition (see A/CN.9/631, recommendations 18, 32, 40, 41 and 85). In any case, the secured creditor cannot receive more that it is owed.

59. However, most States recognize two exceptions to the general principle that a security right in an asset continues to encumber the asset after its transfer, and the Guide does also. The first exception relates to situations in which the secured creditor expressly authorizes the sale (see A/CN.9/631, recommendation 86). A secured creditor may authorize such a sale, for example, because the proceeds are sufficient to secure payment of the secured obligation or because the grantor gives other assets as security. The second exception refers to situations in which the authorization by the secured creditor is inferred, because the encumbered assets are of such a nature that the secured party expects them to be sold free of the security right, or where it is in the best interest of the secured creditor that they be sold free of the security right (see A/CN.9/631, recommendation 87). States have framed this second exception in a number of different ways, as described in the following paragraphs.

(i) The ordinary-course-of-business approach

60. One approach taken in many jurisdictions is to provide that sales of encumbered assets consisting of inventory made by the grantor in the ordinary course of its business will result in the automatic extinction of any security rights that the secured creditor has in the assets without any further action on the part of

the buyer, seller or secured creditor. The corollary to this rule is that when a sale of inventory is outside the ordinary course of the grantor's business, or when the sale relates to an asset other than inventory, the exception will not apply; such a sale does not extinguish the security right and the secured creditor may, upon a default by the grantor, enforce its security right against the encumbered asset in the hands of the buyer (unless, of course, the secured creditor has consented to the sale). Where the security agreement so provides, the sale itself may constitute a default entitling the secured creditor to enforce its security rights; otherwise, the secured creditor cannot do so until default has occurred (see A/CN.9/631, recommendation 87, subpara. (a)).

61. Under this approach, two requirements must be satisfied for the encumbered asset to be sold free of the security right. The first requirement is that the seller of the encumbered assets must be in the business of selling assets of that kind. Thus, the encumbered asset cannot be something that the seller does not typically sell. In addition, the sale cannot be concluded in a manner different than the manner typically followed by the seller (e.g. a sale by the seller outside of its typical distribution channels, as would be the case if the seller normally sells only to retailers and the sale at issue is to a wholesaler). The second requirement is that the buyer must not have knowledge that the sale violates the rights of a secured creditor under a security agreement (for a rule of interpretation with respect to "knowledge", see Introduction, sect. B, Terminology and rules of interpretation, para. […]). This would be the case, for example, if the buyer had knowledge that the sale was prohibited by the terms of the security agreement. On the other hand, mere knowledge on the part of the buyer of the fact that the asset was subject to a security right would be insufficient. This approach has the advantage that it is consistent with the commercial expectation that the grantor will sell its inventory of goods (and indeed must sell it to remain financially viable), and that buyers of the goods will take them free and clear of existing security rights. Without such an exception to the principle that the security right continues in the asset in the hands of a buyer, a grantor's ability to sell goods in the ordinary course of its business would be greatly hampered, because buyers would have to investigate claims to the goods prior to purchasing them. This would result in significant transaction costs and would greatly impede ordinary-course transactions.

62. This approach provides a simple and transparent basis for determining whether goods are sold free and clear of security rights. For example, the sale of equipment by an equipment dealer to a manufacturer that will use the equipment in its factory is clearly a sale of inventory in the ordinary course of the dealer's business, and the buyer should automatically take the equipment free and clear of any security rights in favour of the dealer's creditors. This result is in line with the expectations of all parties, and the buyer is certainly entitled to presume that both the seller and any secured creditor of the seller expect the sale to take place in order to generate sales revenue for the seller. On the other hand, a sale by the dealer of a large number of machines in bulk to another dealer would presumably not be in the ordinary course of the dealer's business.

63. With respect to sales that are outside the ordinary course of the grantor's business, as long as the creditor's security right is subject to registration in a general security rights registry, the buyer may protect itself by searching the registry to

determine whether the asset it is purchasing is subject to a security right and, if so, seek a release of the security right from the secured creditor.

64. In some jurisdictions, buyers of encumbered assets are permitted to take the assets free of the security right, even where the transaction is outside the ordinary course of the seller's business, if the assets are low-cost items, for the reason that, in those jurisdictions, the secured transactions law does not permit registration of a security right in a low-cost item, or because the cost of registrations is high in relation to the cost of the asset, and it would be unfair to impose that cost on a buyer of the item. On the other hand, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in setting arbitrary limits, which would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors.

65. In some jurisdictions that have a registration system that is searchable only by the grantor's name, rather than by a description of the encumbered assets, a purchaser that purchases the assets from a seller that previously purchased the assets from the grantor (a "remote purchaser") obtains the assets free of the security rights granted by such grantor. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset and, accordingly, have no reason to conduct a search against the previous owner. The problem with this approach is that impairs the reliability of a security right given by a seller because of the possibility that the asset will be sold without the secured creditor's knowledge to a remote buyer, either innocently or with the specific intention of stripping away the security right. However, this cost is outweighed by the policy in favour of protecting buyers. For this reason, the Guide recommends that, where a buyer of tangible property takes free of a security right granted by its seller, a remote buyer will also take free of the security right (see A/CN.9/631, recommendation 88).

66. One disadvantage of the ordinary-course-of-business approach is that it might not always be clear to a buyer (particularly in international trade) what activities might be within the ordinary course of the seller's business. Another disadvantage might be that, if this rule were applied only to sales of inventory and not sales of other goods, there could be confusion on the part of the buyer as to whether the goods it is buying constitute inventory of the seller. On the other hand, it should be noted that, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved and in these situations the ordinary-course-of-business approach would be consistent with the expectations of the parties. Therefore, the number of cases in which such confusion exists are rare in practice. On balance, the benefits of the ordinary-course-of-business approach outweigh its disadvantages. This approach facilitates commerce and allows secured creditors and buyers to protect their respective interests in an efficient and cost-effective manner without undermining the promotion of secured credit (see A/CN.9/631, recommendation 87, subpara. (a)).

(ii) Other approaches

67. Many States have taken a different approach to determining whether a buyer of encumbered assets takes title to the assets free of a security right created by the seller. In those States, a buyer of goods takes free of any security rights in the goods if the buyer purchases the goods in good faith (i.e. with no actual or constructive knowledge of the existence of the security rights) and without regard to whether the sale was in the ordinary course of business of the seller. One argument in favour of this approach is that good faith is a notion known to all legal systems and there exists significant experience with its application both at the national and international levels. It has also been argued that a presumption should exist that a buyer is acting in good faith unless it is proven otherwise. However, the problem with such an approach is that it focuses on a subjective criterion relating to the disposition of the buyer (which also raises evidentiary issues), rather than on the commercial expectations of all parties involved.

(c) Rights of lessees

68. Priority disputes sometimes arise between the holder of a security right in an asset granted by the owner/lessor of the asset that is effective against third parties and a lessee of such asset. In this context, the issue is not whether the lessee actually takes the asset free of the security right in the sense that the security right is cut off. Rather, the issue is whether the lessee's right to use the leased asset on the terms and conditions set forth in the lease agreement are unaffected by the security right. The principal issue in this situation is whether, if the holder of such a security right enforced it, the lessee could nevertheless continue using the asset so long as it continued to pay rent and otherwise abide by the terms of the lease. The general principle discussed above (see para. 58) applies here as well. The asset is, in principle, subject to the security right and thus the secured creditor may enforce its security right upon default of the grantor, even if it means interrupting the use of the asset by the lessee under the terms of the lease.

69. As in the case of buyers of tangible property subject to a pre-existing security right, many jurisdictions recognize two exceptions to this general principle. Under either exception, the security right does not cease to exist. However, for the duration of the lease, the right of the secured creditor is limited to the lessor's interest in the property and the lessee may continue to enjoy uninterrupted use of the asset in accordance with the terms of the lease.

70. The first exception is a situation in which the secured creditor has authorized the grantor to enter into the lease unaffected by the security right (see A/CN.9/631, recommendation 86, subpara. (b) (i)).

[*Note to the Commission: The Commission may wish to note that commentary with respect to the issue addressed in recommendation 86, subparagraph (b) (ii), will be added if the Commission decides that this subparagraph should be retained (see A/CN.9/631, recommendation 86, subpara. (b) (ii), note).*]

71. The second exception relates to situations in which the lessor of the tangible property is in the business of leasing tangible property of that type, the lease is entered into in the ordinary course of the lessor's business and the lessee had no actual knowledge that the lease violated the rights of the secured creditor under the security agreement (see A/CN.9/631, recommendation 87, subpara. (b)). Such

knowledge would exist if, for example, the lessee knew that the security agreement creating such security right specifically prohibited the grantor from leasing the property. However, the mere knowledge of the existence of the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the rights of the lessee. This exception is based on similar policy considerations to those relating to the analogous exception for sales of goods in the ordinary course of the seller's business (see para. 66 above).

72. An effective secured transactions regime must also address the issue of a sub-lease. In situations in which the rights of a lessee of tangible property are deemed to be unaffected by a security right in the property granted by the lessor, it is generally considered appropriate that the rights of a sub-lessee will also be unaffected (see A/CN.9/631, recommendation 88).

(d) Rights of licensees

73. The same issues discussed above also arise in the context of licensing of intangible property that is subject to a security right created by the licensor and the general principle applicable to sales and leases of tangible property also applies to licences of intangible property (see A/CN.9/631, recommendation 85). Thus, if a security right in intangible property is effective against third parties, it will continue in the property in the hands of the licensee unless one of the exceptions mentioned below applies (see A/CN.9/631, recommendations 86 and 87).

74. The first exception is where the secured creditor has authorized the licence (see A/CN.9/631, recommendation 86, subpara. (b) (i)). As in the case of sales and leases of tangible property, it is generally thought to be unfair to penalize a licensee if the secured creditor has consented to the licensing.

75. The second exception (also analogous to similar exceptions for sales and leases of tangible property) is a situation involving a non-exclusive licensing of intangible property, where the licensor is in the business of granting non-exclusive licences of such property, the lease is entered into in the ordinary course of the licensor's business, and the licensee had no knowledge that the licence violated the rights of the secured creditor under the security agreement (see A/CN.9/631, recommendation 87, subpara. (c)). As in the case of sales and leases of tangible property, it is generally recognized that such knowledge would exist if, for example, the licensee knew that the security agreement creating such security right specifically prohibited the grantor from licensing the property. However, the mere knowledge of the existence of the security right, as evidenced by a notice registered in the security registration system, would not be sufficient to defeat the rights of the licensee.

76. It is important to note that this second exception relates only to non-exclusive licences of intangible property and does not apply to exclusive licences. Where a grantor is engaged in the business of licensing intangible property, a secured creditor holding a security right in the property generally will normally expect its grantor to grant non-exclusive licences of the property in order to generate revenues. Moreover, it is not reasonable to expect the licensee under a non-exclusive licence to search the general security rights registry to ascertain the existence of security rights in the licensed property. On the other hand, an exclusive licence of intangible property, under which the licensee is granted the exclusive

right to use the property throughout the world, or even in a specific territory, is generally a negotiated transaction that is out of the ordinary course of the licensor's business. In the case of an exclusive licence, it is reasonable to expect the licensee to search the general security rights registry to determine if the licensed property is subject to a security right created by the licensor and to obtain an appropriate waiver or subordination of priority.

77. Finally, as in the case of sales and leases of tangible property, a secured transactions regime must address the case of sub-licensees. And, as with sales and leases, a strong argument exists in favour of ensuring that sub-licensee is unaffected by a security right created by the original licensor in those situations where the law deems the licence itself to be unaffected by the security right (see A/CN.9/631, recommendation 88).

(e) Rights of donees

78. The position of a recipient of an encumbered asset as a gift (a "donee") is somewhat different from that of a buyer or other transferee for value. Because the donee has not parted with value, there is no objective evidence of detrimental reliance on the grantor's apparently unencumbered ownership. As a result, in a priority dispute between the donee of an asset and the holder of a security right in the asset granted by the donor, a strong argument exists in favour of awarding priority to the secured creditor, even in circumstances where the security right was not otherwise effective against third parties. Accordingly, the general rule is that a security right follows the asset in the hands of a transferee (see A/CN.9/631, recommendation 85) and exceptions are made only for transferees for value, such as buyers, lessees or licensees (see A/CN.9/631, recommendations 86-88).

12. Priority of preferential claims

79. In many jurisdictions, as a means of achieving a general social goal (e.g. protection of tax revenue or employee wages), certain unsecured claims are given priority, within or even outside insolvency proceedings, over other unsecured claims and, in some cases, over secured claims (including secured claims previously registered). For example, to protect claims of employees and the State, claims for unpaid wages and unpaid taxes are in some jurisdictions given priority over previously existing security rights. Because social goals differ from jurisdiction to jurisdiction, the precise nature of these claims (e.g. whether they relate to taxes, employee-related claims or other types of claims) and the extent to which they are afforded priority, also differ.

80. The advantage of establishing these preferential claims is that a social goal may be furthered. The possible disadvantage is that these types of priorities can proliferate in a fashion that reduces certainty among existing and potential creditors, thereby impeding the availability of secured credit. In addition, even if the preferential claims can be ascertained with certainty by an existing or potential creditor, such claims (whether arising within or outside of insolvency proceedings) will adversely affect the availability and cost of secured credit. The reason is that, as such claims diminish the economic value of an asset to a secured creditor, creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate or by withholding the estimated amount of such claims from the available credit.

81. To avoid discouraging secured credit, the availability of which is also a social goal, the various social goals should be carefully weighed in deciding whether to provide a preferential claim. The trend with respect to preferential claims in modern legislation is that they are limited and permitted only to the extent that there is no other effective means of satisfying the underlying social objective and when the jurisdiction has determined that the impact of such claims on the availability of secured credit is acceptable. For example, in some jurisdictions, tax revenue is protected through incentives on company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund.

82. If preferential claims exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims in advance and to protect itself. Some jurisdictions have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other jurisdictions have achieved it by requiring that preferential claims be registered in a public registry and by according priority to such claims only over security rights registered thereafter. In those jurisdictions, priority is awarded to security rights that are registered before the preferential claims are registered to the extent they secure obligations in existence as of the date the preferential claim is registered or obligations arising within a specified period thereafter (such as 45 60 days after the preferential claims are registered), if the pre-existing security rights secure a commitment to provide future advances. However, a problem with adopting a registration requirement with respect to some preferential claims that arise immediately prior to an insolvency proceeding is that it may be difficult to calculate their amount or to file in time. The Guide seeks to achieve a balance with respect to preferential claims by not recommending registration of such claims, but rather recommending that the law should limit such claims, both in number and amount, and that, to the extent preferential claims exist, they should be described in the law in a clear and specific way (see A/CN.9/631, recommendation 89). In this way, prospective secured creditors can evaluate the possibility of such claims in deciding whether to extend secured credit.

13. Priority of rights of judgement creditors

83. In some legal systems, a security right that is effective against third parties is accorded priority over the rights of an unsecured creditor, unless the unsecured creditor has obtained a judgement with respect to its claim and has taken the actions prescribed by law to enforce the judgement (such as seizing specific property or registering the judgement).

84. Judgement creditors are given this priority in recognition of the legal steps they have taken to enforce their claims on the grounds that this result is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement but have not taken the time and the expense to do so. However, to avoid giving judgement creditors excessive powers in legal systems where a single creditor may institute insolvency proceedings, insolvency laws often provide that security rights arising from judgements obtained within a specified period of time prior to the insolvency proceeding may be avoided by the insolvency representative. In various jurisdictions, the judgement creditor’s property right is extinguished or not recognized in the judgement debtor’s insolvency proceeding.

85. Effective secured transactions regimes typically address this type of priority dispute by balancing carefully the interests of the judgement creditor and the secured creditor. On the one hand, the judgement creditor has an interest in knowing at a certain point of time whether there is sufficient value left unencumbered in the grantor's assets for the enforcement of the judgement. On the other hand, a strong policy argument exists in favour of protecting the rights of the secured creditor, on the ground that the secured creditor expressly relied on its security right as a basis for extending credit.

86. Many legal systems seek to achieve this balance by giving priority to a security right over a property right of a judgement creditor, so long as the security right became effective against third parties before the judgement creditor's property right arises (see recommendation 90). There are one exception and two limitations to this rule.

87. The exception relates to acquisition financing rights in encumbered assets other than inventory or consumer goods. Priority is accorded to the acquisition financing right even if it is not effective at the time the judgement creditor obtains rights in the encumbered assets, so long as the security right is made effective against third parties within the applicable grace period provided for such security rights. A contrary rule would create an unacceptable risk for providers of acquisition financing that had already extended credit prior to the time when the judgement creditor obtained its property right, and thus would discourage acquisition financing (see A/CN.9/631, recommendation 194).

88. The limitations to the rule mentioned above relate to limitations in the amount of credit given priority. The first limitation arises from the need to protect existing secured creditors from making additional advances based on the value of assets subject to judgement rights. There should be a mechanism to put creditors on notice of such judgement rights. In many jurisdictions in which there is a registration system, this notice is provided by subjecting judgement rights to the registration system. If there is no registration system or if judgement rights are not subject to the registration system, the judgement creditor might be required to notify the existing secured creditors of the existence of the judgement. In addition, the law may provide that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement right is registered (or after the creditor receives notice), so that the creditor can take steps to protect its rights accordingly. The less time an existing secured creditor has to react to the existence of judgement rights and the less public such judgement rights are made, the more their potential existence will negatively affect the availability and cost of credit facilities that provide for future advances.

89. The Guide recommends the secured creditors on record should be notified and that the priority of any security right should extend to credit extended by the secured creditor a certain number of days (e.g. 30-60) after the secured creditor had been notified of the existence of the judgement creditor's right (see A/CN.9/631, recommendation 90, subpara. (a)). Although this limitation imposes an obligation on the judgement creditor to notify the secured creditor of its right, that is generally not overly burdensome for the judgement creditor and relieves the secured creditor of the obligation to search frequently for judgements against the grantor (which would be a far more burdensome and costly obligation). The existence of the grace period is justified on the ground that it prevents the secured creditor under a revolving loan

facility or other credit facility providing for future extensions of credit from having to cut off loans or other credit immediately, a circumstance that could create difficulties for a grantor or even force a grantor into insolvency.

90. The second limitation relates to future advances. The priority of a security right may be extended to advances made even after the secured creditor is notified of the judgement creditor's rights, provided the advance was irrevocably committed, prior to that notice, in a fixed amount or an amount that may be determined pursuant to a specified formula (see A/CN.9/631, recommendation 90, subpara. (b)). A security right securing credit not committed but extended before the secured creditor is notified of the judgement creditor's rights does not have priority on the ground that the judgement creditor should be able to determine at some point in time whether any value would be left for the judgement creditor to enforce the judgement.

91. The rationale for this rule is that it would be unfair to deprive a secured creditor that has irrevocably committed to extend credit of the priority that it relied on when entering into the commitment. The contrary argument is that, under many credit facilities, the existence of a judgement would constitute an event of default, entitling the secured creditor to cease extending additional credit. However, that result would be unfair to the grantor, because the sudden loss of credit could well force the grantor into an insolvency proceeding. By recommending this rule, the Guide resolves this priority dispute in favour of the continued extension of credit under an irrevocable credit facility, in the interest of allowing the grantor to remain in business (a circumstance that may result in the greatest chance for the grantor to pay all of its obligations).

14. Priority of rights of persons providing services with respect to an encumbered asset

92. In some legal systems, creditors that have provided services with respect to or have added value to tangible encumbered assets in some way, such as by storing, repairing or transporting them, are given a property right in the assets while the assets are in the possession of the service providers. This treatment of service providers has the advantage of inducing them to continue providing services and of facilitating the maintenance and preservation of encumbered assets.

93. In many jurisdictions, the property right given to service providers in assets in their possession ranks ahead of other security rights in those assets. The rationale underlying this priority rule is that service providers are not professional financiers and should be relieved of searching the registry to determine the existence of competing security rights before providing services. Moreover, the rule facilitates services such as repairs and other improvements that often benefit secured creditors.

94. A question arises as to whether the priority given to service providers should be limited in amount or recognized only in certain circumstances. One approach is to limit priority to an amount (such as one month's rent in the case of landlords) and to recognize their priority over pre-existing security rights only where value is added which directly benefits the holders of the pre-existing security rights. This approach would have the advantage that the rights of secured creditors would not be unduly limited. It would have the disadvantage though that service providers that did not add value would not be protected and, in any case, the amount of the value

added by the service providers would need to be determined, a requirement that may add costs and create litigation.

95. Another approach is to limit the priority of service providers to the reasonable value of services provided. Such an approach would reflect a fair and efficient balance between the conflicting interests. It would ensure reasonable protection of service providers, while avoiding difficult questions of proof as to the relative value of the encumbered assets before and after the services are rendered (see A/CN.9/631, recommendation 91).

15. Priority of a supplier's reclamation right

96. In many legal systems, a supplier selling goods on unsecured credit may, upon default or financial insolvency of the buyer, be given by law a right to reclaim the goods from the buyer within a specified period of time (known as the "reclamation period"). If an insolvency proceeding has commenced with respect to the buyer, applicable insolvency law will determine the extent to which the reclamation claimants would be stayed or their rights would otherwise be affected (see recommendations 39-51 of the UNCITRAL Insolvency Guide).

97. An important question is whether a reclamation claim relating to specific tangible property should have priority over a pre-existing security right in the same property. In other words the question is whether, if the inventory of the buyer (including the property sought to be reclaimed), is subject to effective security rights in favour of a secured creditor, the reclaimed property should be returned to the seller free of such security rights. In some jurisdictions, the reclamation has a retroactive effect, placing the seller in the same position it was prior to the sale (i.e. holding property that was not subject to any security rights in favour of the buyer's creditors). However, in other jurisdictions the property remains subject to the pre-existing security rights, provided that the security right had become effective against third parties before the supplier exercises its reclamation right, on the basis that any other result would be unfair to a pre-existing creditor of the buyer that had relied on the existence of such property in extending credit, and would also promote uncertainty and thereby discourage inventory financing (see A/CN.9/631, recommendation 92).

16. Priority of a security right in an attachment

98. To the extent that a secured transactions regime permits security rights to be created in attachments to immovable property (as recommended by this Guide; see A/CN.9/631, recommendation 22), it includes rules governing the relative priority of a holder of security rights in an attachment to immovable property vis-à-vis persons that hold rights with respect to the related immovable property. A paramount consideration of such priority rules is to avoid unnecessarily disturbing well-established principles of immovable property law.

99. Such priority rules address a number of different priority conflicts. The first is a priority conflict between a security right in an attachment (or any other right in an attachment such as the right of a buyer or a lessee), that is created and made effective against third parties under immovable property law, on the one hand, and a security right in the attachment that is made effective against third parties under the movable property secured transactions regime, on the other hand. In this situation,

out of deference to immovable property law, priority is accorded to the right created under immovable property law (see A/CN.9/631, recommendation 93).

100. A second priority conflict may arise between: (a) a security right in an encumbered asset that is either an attachment to immovable property at the time the security right becomes effective against third parties or that becomes an attachment to immovable property subsequently; and (b) a security right in the attachment (or other right in the attachment such as the right of a buyer or lessor) in the related immovable property. In this case, priority is accorded to the right described under (a), on the ground that, as both competing security rights achieved third-party effectiveness in the immovable property registry, priority should be determined according to the order of registration in the immovable property registry in order to preserve the reliability of that registry (see A/CN.9/631, recommendation 94).

101. The general rules applicable to the priority of security rights in movable property apply to priority conflicts between security rights in attachments to movable property. A special rule may be required to address a priority conflict between: (a) a security right in an attachment (or any other right in an attachment such as the right of a buyer or lessee) that was made effective against third parties by registration in a specialized registry or notation on a title certificate; and (b) a security right or other right in the related movable property that is registered subsequently. Typically, priority is given to the right under (a) in deference to the policy in favour of preserving the integrity of specialized registries and title-notation systems (see A/CN.9/631, recommendation 95).

17. Priority of a security right in a mass or product

102. There are three types of potential priority contests that require special rules. Using the example of the ingredients in a cake, these three types are: (a) contests between security rights taken in the same items of tangible property that ultimately become part of a mass or product (e.g. sugar and sugar); (b) contests involving security rights in different items of tangible property that ultimately become part of a mass or product (e.g. sugar and flour); and (c) contests involving a security right originally taken in separate tangible property and a security right in the mass or product (e.g. sugar and cake).

(a) Priority of security rights in the same items of tangible property that become part of a mass or product

103. Security rights in items of tangible property that become commingled normally have the same priority vis-à-vis each other as they had in the separate property. The rationale for this rule is that the incorporation of tangible property into a mass or product should have no bearing on the respective rights of creditors with competing security rights in the separate items of tangible property (see A/CN.9/631, recommendation 96). This rule is predicated on the assumption that a secured creditor may not receive an amount greater than the value of the tangible property immediately before it became part of the mass or product (see A/CN.9/631, recommendation 23).

(b) Priority of security rights in different items of tangible property that become part of a mass or product

104. If security rights in different items of tangible property that ultimately become part of a mass or product continue in the mass or product, the security rights have the same priority and the issue is to determine the relative value of the rights. Normally, the secured creditors are entitled to share in the aggregate maximum value of their security rights in the mass or product according to the ratio of the value of their security rights (see A/CN.9/631, recommendation 97). Using the example of the cake, if the value of the sugar is 2 and the flour 5, while the value of the cake is 6, the creditors will receive two sevenths and five sevenths of 6, but neither secured creditor will receive more than the amount of its secured obligation. In any case, if the value of the mass or product is less than the amount of the secured obligations, there will be no value left for unsecured creditors.

(c) Priority of a security right originally taken in different items of tangible property as against a security right in the mass or product

105. Security rights in items of tangible property have priority over all security rights in the mass or product that extend to future property only if the former are acquisition security rights (see A/CN.9/631, recommendation 98). Otherwise, the general priority rules apply. This rule is intended to promote the availability of credit for the acquisition of tangible property, without which no mass or product could be produced.

B. Asset-specific remarks

106. This section of the commentary discusses issues with respect to security rights in types of asset that require special priority rules. Security rights in types of asset to which the general rules apply (e.g. tangible property or receivables) are discussed in section A above.

1. Priority of a security right in a negotiable instrument

107. Many jurisdictions have adopted special priority rules for security rights in negotiable instruments, such as cheques, bills of exchange and promissory notes (for the definition of “negotiable instrument”, see Introduction, sect. B, Terminology and rules of interpretation, para. […]). These rules are a reflection of the importance of the concept of negotiability in those jurisdictions.

108. As discussed (see chap. V, Effectiveness of a security right against third parties, paras. […]), in many jurisdictions security rights in negotiable instruments may be made effective either by registration of the security right in the general security rights registry or by transfer of possession of the instrument (see A/CN.9/631, recommendation 38). In these jurisdictions, priority is often accorded to a security right made effective against third parties by transfer of possession of the instrument over a security right made effective against third parties by registration, regardless of when registration occurs (see A/CN.9/631, recommendation 99). The rationale for this priority rule is that it resolves the priority conflict in favour or preserving the unfettered negotiability of negotiable instruments.

109. For the same reason, in those jurisdictions, priority is often accorded to a buyer or other transferee (in a consensual transaction), if that person either qualifies as a protected holder of the instrument under the law governing negotiable instruments (for a rule of interpretation with respect to the expression "law governing negotiable instruments", see Introduction, sect. B, Terminology and rules of interpretation, para. […]) or takes possession of the instrument and gives value in good faith and without knowledge that the transfer is in violation of the secured creditor's rights (see A/CN.9/631, recommendation 100). It should be noted in this regard that knowledge of the existence of a security right on the part of a transferee of an instrument or a document does not mean, by itself, that the transferee did not act in good faith.

2. Priority of a security right in a right to payment of funds credited to a bank account

110. A comprehensive priority regime typically addresses a number of different priority conflicts relating to security rights in rights to payment of funds credited to a bank account (for a definition of "bank account", see Introduction, sect. B, Terminology and rules of interpretation, para. […]). One type of priority conflict is between a security right made effective against third parties by control and a security right made effective against third parties by a method other than control. In this situation, many jurisdictions accord priority to the security right made effective against third parties by control, because that outcome facilitates financial transactions that rely on funds credited to a bank account, relieving secured creditors from the necessity of searching the general security rights registry (see A/CN.9/631, recommendation 101, first sentence). In a sense, the existence of a control agreement in this situation functions like a specialized security rights registry.

111. Another type of priority conflict is a conflict between two security rights, each of which is made effective by control. Here, the logical outcome is to accord priority to the security right that was first made effective by control (see A/CN.9/631, recommendation 101, second sentence). This conflict will not arise often in practice, because it is unlikely that a depositary bank will knowingly enter into more than one control agreement with respect to the same bank account in the absence of an agreement between both secured creditors as to how priority will be determined.

112. Yet another type of priority conflict is where one of the secured creditors is the depositary bank itself. In this situation, a strong argument exists in favour of according priority to the depositary bank (see A/CN.9/631, recommendation 101, third sentence), because that depositary bank generally will win in such a situation in any event by reason of its right of set-off under non-secured transactions law and a priority rule that favours the bank in this circumstance allows the conflict to be resolved within the confines of the secured transactions regime without resorting to other law. If a different rule were adopted, depositary banks would be reluctant to enter into any control agreements and, in any case, a secured creditor could obtain a subordination agreement from the bank before deciding to extend credit.

113. Jurisdictions that adopt this priority rule often make an exception for the circumstance in which the priority conflict is between the depositary bank and a secured creditor that obtains control of the bank account by becoming the customer

of the depositary bank, and adopt a rule that accords priority to the customer. The rationale for this approach is that, by accepting the competing secured creditor as its customer, the depository bank effectively agrees to subordinate its claim. Also, the depositary bank would often lose its right of set-off in this situation because there would be no mutuality between the depository bank and the grantor since the bank account is not in the grantor's name.

114. A fourth type of conflict is a conflict between a security right in a right to payment of funds credited to a bank account and any rights of set-off the depositary bank might have against the grantor-client. To avoid undermining the bank-client relationship, secured transactions laws give priority to the depositary bank's rights of set-off (see A/CN.9/631, recommendation 102).

115. A fifth type of priority conflict is a conflict between a security right in a right to payment of funds credited to a bank account and a transferee of funds from the bank account initiated by the grantor. In this situation, a strong policy argument in favour of the free negotiability of funds supports a rule that accords priority to the transferee, so long as the transferee did not act in collusion with the holder of the bank account to deprive the secured creditor if its security right. Thus if the transferee takes the funds with knowledge that the transfer violates the security right under the security agreement, it takes the funds subject to the security right. The term "transfer of funds" is intended to cover a variety of transfers, including by cheque and electronic means of communication. (see A/CN.9/631, recommendation 103).

3. Priority of a security right in money

116. In the interest of maximizing the negotiability of money, many secured transactions regimes permit a transferee of money to take the money free of the claims of other persons, including the holders of valid security rights in the money (for the definition of "money", see Introduction, sect. B, Terminology and rules of interpretation, para. […]). As in the case of transferees of funds from a bank account, the only exception to this priority rule is if the transferee has colluded with the holder of the bank account to deprive the secured creditor if its rights (e.g. if the transferee has knowledge that the transfer of the money is in violation of the security agreement between the account holder and the secured party. On the other hand, mere knowledge of the existence of the security right does not defeat the rights of the transferee under this rule (see A/CN.9/631, recommendation 104).

4. Priority of a security right in proceeds under an independent undertaking

117. As already mentioned (see chap. V, Effectiveness of a security right against third parties, see para. […]), a security right in proceeds under an independent undertaking is made effective against third parties only by control. As the typical method of achieving control in this context is by obtaining an acknowledgment, in the case of several potential payors (e.g. the guarantor/issuer, confirmer and several nominated persons), control is achieved only vis-à-vis each particular guarantor/issuer, confirmer or nominated person that gave an acknowledgment. Thus, the priority rule normally focuses on the particular person that is the payor.

118. Normally, a security right in proceeds under an independent undertaking that has been made effective by control, has, with respect to a particular

guarantor/issuer, confirmer or nominated person that has given value under the independent undertaking, priority over all other security rights that have, with respect to that person, been made effective by a method other than control. As in the case of bank accounts (see para. 110 above), this rule is based on the need to facilitate transactions involving independent undertakings by relieving parties of the necessity of searching the general security rights registry. However, as between two security rights made effective against third parties by acknowledgement, priority is accorded to the first security right to be acknowledged (see A/CN.9/631, recommendation 105).

5. Priority of a security right in a negotiable document or goods covered by a negotiable document

119. Effective secured transactions regimes typically have rules that address at least two priority conflicts involving negotiable documents, such as negotiable warehouse receipts and bills of lading (for the definition of "negotiable document", see Introduction, sect. B, Terminology and rules of interpretation, para. […]). The first is a conflict between the holder of a security right in a negotiable document or the goods covered thereby, on the one hand, and a person to whom the document has been duly negotiated, on the other. In the interest of preserving negotiability under non-secured transactions law, priority is generally accorded to the transferee of the document (see A/CN.9/631, recommendation 106).

120. The second conflict is between the holder of a security right in the goods covered by the negotiable document that is derived from a security right in the negotiable document and the holder of a security right in the goods resulting from another method (e.g. the creation of a direct security right in the goods). This type of conflict can arise in two distinct situations. One situation is where the security right in the goods was created while the goods were subject to the negotiable document. Here, a strong argument exists in favour of awarding priority to the holder of the security right in the document (see A/CN.9/631, recommendation 107). The second situation is where the security right in the goods became effective before the goods were covered by the negotiable document. In this situation, it is fair to award priority to that security right.

C. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.*]