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Addendum

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XIII. Transition

A. General remarks

1. The need for transition provisions

1. The previous chapter addressed "conflict of laws", that is, the set of rules to determine, in cases where two or more legal systems have substantive rules that might apply to a particular transaction, which substantive rules will in fact apply. Often these conflict-of-laws rules are described as rules governing conflict of laws "in space", in order to distinguish them from a different type of conflict-of-laws rules (i.e. those governing conflict of laws "in time"). All legislative action raises issues relating to the conflict of laws in time. Hence, most States have well-developed principles to determine, when a new law comes into force, its impact on inconsistent prior law and the extent of its application to existing legal relationships. Where, however, a major reform to existing law is contemplated, States usually incorporate into the reform statute specific rules governing conflict of laws in time as they arise in connection with the coming into force of the new law. These rules are typically known as "transition provisions". In view of the scope of preceding chapters, the Guide recommends that States adopt a series of transition provisions tailored specifically to the new law they may enact.

2. The rules embodied in new secured transactions legislation reflecting the recommendations of the Guide are likely to depart in significant ways from the rules in the secured transactions law predating the legislation. Those differences will have an obvious impact on any agreements that grantors and secured creditors conclude after the new legislation is enacted. However, many transactions concluded under the prior law will be ongoing when the new law comes into force. In light of the differences between the old and new legal regimes and the continued existence of transactions and security rights created under the old regime, it is important for the success of the new legislation that it contain fair and efficient rules governing the transition from the old law to the new law. A similar need for transition rules is present when, under the conflict-of-laws rules of the old regime, the law of a different State (i.e. different from the State whose law governs that issue under the conflict-of-laws rules of the new regime) governed the creation, effectiveness against third parties or priority of a security right.

3. Two issues related to the transition from the old regime to the new law must be addressed. First, as discussed in section A.2, the new legislation should provide the date as of which it (or dates as of which its various parts) will come into force (the "effective date"; see recommendation 223). Second, as discussed in section A.3, the new legislation should also set forth the extent to which, after the effective date, the new legislation applies to transactions or security rights that existed before the effective date.

2. Effective date of new legislation

4. A number of factors require consideration in determining the effective date of the legislation. Prompt realization of the economic advantages of new legislation is a reason for States to bring the new law into force as soon as possible after enactment. These advantages must be balanced, however, against the need to avoid

causing instability in, or disruption of, the markets that will be governed by the new legislation, and to allow market participants adequate time to prepare for conducting transactions under the new legislation, which may be significantly different from transactions under the prior law. Accordingly, and depending on the extent to which the new legislation had been the subject of public discussion (including substantial educational programmes for judges, lawyers and market participants), a State may conclude that the effective date of the new legislation should be some period of time after the enactment of the new legislation, in order for these markets and their participants to adjust their conduct in preparation for the new rules.

5. In determining the effective date, States might consider various factors including the following: the impact of the effective date on credit decisions; maximization of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonization of the new secured transaction legislation with other legislation; constitutional limits, if any, to the retroactive effect of new legislation; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

6. States generally adopt one of three methods for bringing legislation into force at a date subsequent to enactment. First, it is provided that a law comes into force on a future date fixed by a "decree" or a "proclamation". In other cases, the law itself will specify that future date. For example, if a law were enacted on 17 January of a given year, that law might simply provide that it comes into force on 1 September of the same year. In still other cases, the legislation will contain a specific formula for determining its effective date. For example, the law might provide that the effective date will be the first day of the calendar month following the expiration of six months after the date of enactment. A second formula might refer to the first day of January or July, whichever occurs first, following the expiration of six months after the date of enactment. Under a third formula, it is necessary to delay the effective date in order to allow time to build a technical infrastructure (such as a computerized registry). In these cases, States often use a "decree" to the effect that, for example, the date the registry becomes operational will be the starting point for the six-month or longer delay. The Guide recommends that States either specify the effective date, or set out a formula for determining the effective date in the law itself (recommendation 223).

7. As debts that are secured by rights in the grantor's assets are often payable over a period of time, it is likely that there will be many rights created before the effective date that will continue to exist on and after the effective date, securing debts that are not yet paid. Therefore, States also must consider whether the new legislation should apply to issues that arise after the effective date when these issues relate to transactions entered into prior to the effective date.

8. One approach would be for the new legislation to apply prospectively only and, therefore, not to govern any aspects of any transactions entered into prior to the effective date. While there might be some appeal in such a solution, especially with respect to issues that arise between the grantor and the secured creditor, such an approach would create significant problems, especially with respect to priority issues. Foremost among those problems would be the necessity of resolving priority disputes between a secured creditor that obtained its security right prior to the

effective date and a competing secured creditor that obtained its security right in the same encumbered assets after the effective date. Because priority is a comparative concept, and the same priority rule must govern the two security rights that are being compared, it is not practicable for the old rules to govern the priority of the security right of the pre-effective-date creditor and the new rules to govern the priority of the security right of the post-effective-date creditor. Determining which priority rule to apply to such priority disputes is not without difficulty. Applying the old rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new legislation, with the result that significant economic benefits of the new legislation could be deferred for a substantial period. The delay would affect all new transactions even though it would be needed for only some of the old transactions. Moreover, the delay would prevent parties with security agreements that cover future assets from taking advantage of the new law for assets acquired after its effective date. On the other hand, applying the new rules to such priority disputes might unfairly prejudice parties that relied on the old law (especially those parties that relied on the old law without notice that the law might be changed) and might also provide an incentive for such parties to object to the new legislation or advocate an unduly delayed effective date.

9. Alternatively, greater certainty and earlier realization of the benefits of the new legislation could be promoted by applying the new legislation to all transactions as of the effective date, but with such transition provisions as are necessary to assure an effective transition to the new regime without loss of pre-effective-date priority status. Such an approach would avoid the problems identified above and would otherwise fairly and efficiently balance the interests of parties that complied with the old law with the interests of parties that comply with the new law.

10. Taking into account these considerations, the Guide recommends the second of these two general approaches: (a) immediate application of the new law to all transactions arising after its effective date; (b) no general retroactive application of the new law to transactions entered into prior to its effective date; (c) application of the new law to issues and procedures (for example, priority disputes and enforcement mechanisms) arising after its effective date; and (d) adoption of transition provisions to protect the rights that parties acquired under transactions concluded prior to the effective date (recommendation 223, second sentence).

3. Issues to be addressed by transition provisions

(a) General

11. Many security rights created before the effective date of the new law will continue to exist after the effective date and may come into conflict with security rights created under the new law. Clear transition provisions are thus needed to determine the extent to which the rules in the new legislation will apply to those pre-existing security rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction that created a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between a holder of a security right and a competing claimant, when either

the security right or the right of the competing claimant was created before the effective date.

12. No single rule or formula to govern all cases is possible because, even if all States were to implement the Guide in identical fashion, each State would be transitioning from a different pre-existing regime. Further, the particularities of the pre-existing regime will have an effect on the decisions made with respect to transition, such as how easy it will be to determine that assets were subject to a security right under the old regime, or how long transactions could go on "untouched" (e.g. whether, under the old regime, there would not be a need for renewal or other action to maintain third-party effectiveness). The discussion that follows reviews the principal issues that States must address in elaborating a series of transition provisions.

(b) Disputes before a court or arbitral tribunal

13. When a dispute is in litigation at the effective date, the rights of the parties have sufficiently crystallized so that the coming into force of a new legal regime should not change the outcome of that dispute. The same principle should apply when the dispute is taken before a comparable dispute resolution system, such as arbitration, although it should not apply when a system such as conciliation is being used by the parties (as the non-binding character of the result of the proceedings indicates that the rights of the parties have not sufficiently crystallized). It follows, therefore, that such a dispute should not be resolved by application of the new legal regime (see recommendation 224). Moreover, within the context of ongoing enforcement proceedings, parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law. Litigation may involve matters other than enforcement. In these cases, ongoing litigation on one aspect of a secured transaction should not preclude the application of the new law to aspects of the transaction that are not the subject of litigation. Nor should it prevent parties from commencing litigation on any such matters under the new law.

(c) Effectiveness of pre-effective-date rights as between the parties

14. When a security right has been created before the effective date of new legislation, two questions arise regarding the effectiveness of that right between the grantor and the creditor. The first question is whether a security right that was effectively created under the old law but does not fulfil the requirements for creation under the new law will become ineffective on the effective date of the new law. The second question is whether a security right that was not effectively created under old law but fulfils all the requirements for creation of a security right under the new law will become effective on the effective date of the new law.

15. With respect to the first question, different approaches are also possible. For example, a transition period might be created during which the security right would remain effective between the parties, so that the creditor could take the necessary steps for creation under the new law during the transition period. At the expiration of the transition period, if such steps had not been taken the right would become ineffective under the new law. On the other hand, a simpler approach (and the approach adopted by the Guide) is to provide that, if a security right is created (that is, is effective between the parties) before the effective date of the new law, it

remains effective between them after the new law comes into force (see recommendation 225).

16. With respect to the second question, consideration should be given to making the right effective as of the effective date of the new law, since the parties presumably intended the right to be effective as between them when they entered into their agreement. Nonetheless, some States address this issue by requiring a confirmation by the grantor that it intends the previously ineffective right to be effective under the new law. Such a requirement is difficult to put into practice, however, since it presumes, implausibly, that at least one of the parties knew of the defect, failed to do anything to correct it under the old law, but now wishes the security right to be effective. The more likely case involves the discovery of the defect after the new law came in force, in which case a rule providing for automatic effectiveness upon the coming into force of the new law is justified. This is the position implicitly recommended in the Guide (recommendation 223, second sentence).

(d) Effectiveness of pre-effective-date rights as against third parties

17. Different issues arise as to the effectiveness against third parties of a right created before the effective date of the new law. As the new legislation will embody public policy regarding the proper steps necessary to make a right effective against third parties, it is preferable for the new rules to apply to the greatest extent possible. It may, however, be unreasonable to expect a creditor whose right was effective against third parties under the previous legal regime of the enacting State (or under the law of the State whose law applied to third-party effectiveness under the conflict-of-laws rules of the old regime) to comply immediately with any additional requirements of the new law. The expectation would be especially onerous for institutional creditors, which would be required to comply with the additional requirements of the new law simultaneously for large numbers of pre-effective-date transactions.

18. A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules to remain effective for a reasonable period of time (as specified in the transition provisions in the new law) so as to give the creditor time to satisfy the requirements of the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law (see recommendation 226). In determining the length of time within which creditors are permitted to make their existing rights effective against third parties, States should consider a number of practical questions. For example, where a registry system for security rights already exists, a longer period might be contemplated since third parties would continue to have a means to determine if a security right encumbered particular assets. By contrast, where no registry system for security rights is in place, a shorter period might be considered (at least for rights for which a notice was not required to be registered under the old law), since third parties would not have an easy means to determine whether a security right encumbered a potential grantor's assets.

19. If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new rules, the right should be effective against third parties immediately upon the effective date of the

new rules. Once again, the presumption is that the parties intended effectiveness as between them, and third parties are protected to the full extent provided for in the new rules. This is the position implicitly recommended in the Guide (recommendation 223, second sentence).

(e) Priority disputes

20. An entirely different set of questions arises in the case of priority disputes because such disputes necessarily involve applying one set of rules to two (or more) different rights created at different times. A legal system cannot simply provide that the priority rule in effect at the time when a security right was created governs priority with respect to that right because such a rule would not provide a coherent answer when one of the rights that is being compared was created under the former regime while the other was created under the new regime. Rather, there must be rules that address each of the following situations: (a) where both rights are created after the effective date of the new legislation; (b) where both rights are created before the effective date; and (c) where one right is created before the effective date and the other right is created after the effective date.

21. The easiest situation is a priority dispute between competing claimants whose rights were created after the effective date of the new legislation. In that situation, it is obvious that the priority rules in the new legislation should be applied to resolve that dispute.

22. Conversely, if both of the competing rights were created before the effective date of the new legislation and the relative priority of the two competing rights in the encumbered assets was established before the effective date of the new rules and, in addition, nothing (other than the effective date having occurred) has happened that would change that relative priority, stability of relationships suggests that the priority established before the effective date should not be changed merely because the new law came into force. If, however, something occurs after the effective date that would have had an effect on priority under the previous legal regime (such as a security right becoming effective against third parties or ceasing to be effective against third parties), there is less reason to continue to utilize the former law to govern a dispute that has been changed by an action or event that took place after the effective date. There is a much stronger argument for applying the new law to such a situation. In other words, the existing rights of parties as they stood when the new law came into force are protected, but parties should not be relieved of the obligation to make certain that they avoid acting (or failing to act) in such a way that their existing rights are no longer preserved under the new law (see recommendations 227-229).

23. The most difficult transition situation involves a priority dispute between one right that was created before the effective date and another right that was created after the effective date. In such a case, while it is preferable to have the new rules govern eventually (indeed, sooner rather than later), it is appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the old regime, provided that creditor takes whatever steps are necessary to maintain protection under the new regime. If those steps are taken within the time prescribed in the transition rule, the new legislation should provide that creditor with the same priority it would have enjoyed had the new rules been effective at the time of the

original transaction and those steps had been taken in a timely fashion under the old law (see recommendation 227).

(f) Enforcement

24. Disputes may be in litigation (or an alternative dispute resolution system, such as arbitration) at the date when the new law comes into force. As noted, in these cases, the rights of the parties have sufficiently crystallized so that the effectiveness of a new legal regime should not change the outcome of that dispute (see recommendation 224). Parties to the dispute should generally not be able to avail themselves of mechanisms or rights provided in the new law. For example, if non-judicial enforcement is prohibited under prior law, but authorized under the new law, enforcing parties should not be able to convert the judicial enforcement process into a non-judicial enforcement process. Likewise, within the context of ongoing enforcement proceedings, parties should not normally be permitted to invoke defences or other rights contained only in the new law. The scope of the principle is, however, open to interpretation. In one view, once a creditor has commenced enforcement under prior law, it should be deemed to have opted for enforcement under that law, and cannot thereafter attempt to avail itself of recourses available under the new law. In another view, the principle means only that the creditor cannot be forced to convert proceedings commenced under prior law into proceedings under the new law. It may continue to proceed with enforcement as if the new law had not yet come into force. If, however, the enforcing creditor were to abandon ongoing judicial or arbitral enforcement proceedings, in this view, nothing would prevent that creditor from commencing other enforcement proceedings (including non-judicial enforcement proceedings) under the new law. The Guide does not make a recommendation on which of these two approaches States should adopt in respect of ongoing enforcement proceedings.

25. Nonetheless, the vast bulk of disputes that involve transactions entered into before the coming into force of the new law will arise after the new law becomes effective. Two different situations can arise. On the one hand, it may be that secured creditors are entitled to exercise certain recourses and grantors are permitted to plead certain defences that are no longer permitted under the new law. On the other hand, it may be that the new law permits creditors to avail themselves of new remedies and permits debtors to plead new defences not previously permitted.

26. Where the new law abolishes certain remedies, or makes them subject to a new and more onerous procedure, there is an argument that creditors should not be prejudiced by the new law. For example, in some States, creditors in possession may, upon default, simply take the asset given in pledge without having to give notice to the grantor or third parties. The Guide, by contrast, contemplates that a creditor would have to give notice of its intention to accept the assets in satisfaction of the secured obligation (see recommendations 141-145).

27. A similar rationale applies to cases where grantors are deprived of defences or procedural rights that could be exercised under prior law. For example, in some States, grantors in default may suspend enforcement proceedings by remedying the particular omission that led to the default, thereby reinstating the secured obligation and stopping enforcement. The Guide, by contrast, contemplates that grantors have a right to redeem the security by paying the outstanding obligation, but have no right to cure the default and reinstate the obligation (see recommendation 139).

28. In both these cases, there is an argument that the prejudice potentially suffered by a secured creditor or a grantor with the coming into force of the new law is sufficient to justify not abolishing any rights arising under prior law, even in respect of enforcement that commences after the new law comes into force. Both should be able to enforce the original agreement according to the law in force when it was concluded. By contrast, there is an equally strong argument that because the new enforcement regime results from a State carefully considering how best to balance the rights of all parties, it should apply to all post-effective-date enforcement remedies. This argument is particularly persuasive when the enforcement will affect the rights of third parties that have taken security rights in the assets after the new regime comes into force. Moreover, because the relative balance to be struck depends on the particular configuration of secured creditors' enforcement rights and grantors' rights in individual States under prior law, the Guide adopts the general principle of immediate application (see recommendation 223).

29. This said, other law in a State (for example, the general law of obligations or constitutional principles relating to retroactive interference with property rights) may affect the precise extent to which enforcement proceedings commenced after the new law comes into force are affected by the principle of immediate application.

30. As for the case where the new law provides creditors with new remedies, and grantors with new procedural rights, the argument for applying the new law to transactions existing prior to its coming into force is compelling. A secured creditor under prior law that has taken the steps necessary to ensure third-party effectiveness under the new law should be in no different a position than a creditor that initially takes security under the new law. Similarly, any new defences or procedural rights given to grantors and third parties under the new law should be available in connection with enforcement proceedings undertaken by all secured creditors, including those creditors enforcing rights arising under transactions that existed before the new law came into force. That is, the new enforcement regime reflects a State's best judgement as to a fair and efficient regime for enforcing security rights. If it is appropriate for security rights that have been created after the new law came into force, it should also apply to the post-effective-date enforcement of security rights created before the new law came into force.

B. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/637 includes a consolidated set of 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.*]