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# Security interests

## Draft legislative guide on secured transactions

### Note by the Secretariat*

**Addendum**

Contents



* This note is submitted later than the required 10 weeks prior to the start of the meeting because of the need to complete consultations and finalize subsequent amendments.

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# XI. Acquisition financing

## A. General remarks

### 1. Introduction

#### (a) The nature of acquisition financing

1. The purchase and sale of tangible assets (for the definition of “tangible assets” see Introduction, section B, Terminology) is a central activity in a modern commercial economy. Almost every business buys or sells this type of asset at some time or another. For some businesses, such transactions (e.g. the acquisition of raw materials and their subsequent manufacture and sale or the purchase of inventory at wholesale for distribution to retailers or for resale at retail) are a central activity. For other businesses, the purchase and sale of tangible assets is not the central activity, but it is nonetheless important to the extent that a business requires an investment in equipment and this equipment may need to be augmented, upgraded or replaced from time to time.

2. However, the acquisition of tangible assets is not just an activity of businesses. Consumers are constantly purchasing tangible assets. These assets range from low-price consumer goods, through mid-range durable assets such as furniture, electronic devices and kitchen equipment, to high-value assets such as automobiles and recreational vehicles.

3. In many cases, the acquisition of tangible assets by businesses or consumers is on a cash basis. In many other cases, however, needed assets are acquired on credit. Whenever a business or consumer acquires tangible assets on credit, and rights in the assets being acquired serve as security for the credit being extended, the credit transaction is a form of secured transaction, which the Guide calls an “acquisition financing transaction”. The right that the seller or creditor retains or obtains in the assets that are supplied to the buyer or grantor may be called, depending on the precise character of the right, either an acquisition security right, or a retention-of-title right, or a financial lease right (for the definitions of “grantor”, “acquisition security right”, “retention-of-title right” and “financial lease right” see Introduction, section B, Terminology).

4. Acquisition financing transactions are among the most important sources of credit for many buyers of tangible assets. In addition, acquisition financing transactions are critical to many sellers, even when their buyers do not otherwise regularly purchase assets on credit. For example, in many States, the sale of automobiles normally involves an acquisition financing transaction. While buyers may seldom engage in such transactions for other purchases, their availability is critical to the business of automobile sellers. In many respects, acquisition financing transactions are identical to ordinary secured transactions as described in previous sections of the Guide. However, in other respects, they have particular features that have led States to provide for special rules in several situations. This chapter considers the ways in which States may achieve an efficient and effective regime to govern all types of acquisition financing transaction.

5. Because of the number and diversity of acquisition financing transactions today, for the purposes of this chapter it is important to state clearly how the Guide

uses this term, as well as various other terms. In several cases these other terms coincide with terms now in use in many States. The Guide makes a conscious choice in this chapter not to generate new, unfamiliar terms. However, the terms used here are meant to have the meanings provided in the definitions, which may well differ from the meanings in any particular State today.

6. The only new term is the generic concept "acquisition financing transaction". An acquisition financing transaction exists whenever one person may claim a property right in tangible assets to secure another person's obligation to pay any unpaid portion of the purchase price (or its economic equivalent), whether that property right exists in favour of a seller, a lessor or a lender. A transaction under which a seller retains title (ownership) of the assets sold for such a purpose is also an acquisition financing transaction. Thus, the key features of an acquisition financing transaction are two: (a) the credit is used for the specific purpose of enabling the buyer to acquire a tangible asset; and (b) the rights being claimed or retained relate directly to the asset being acquired.

### (b) Diversity of forms of acquisition financing

7. As noted in section B of chapter I (Basic approaches to regulating secured transactions) of the Guide, States have developed a wide variety of legal devices through which providers of credit can ensure repayment of their debtor's obligation. While only some are classically known as security rights, all serve the economic function of securing the repayment obligation.

8. A similar, if not even greater, diversity of legal devices is typically available to those (often sellers) that finance a buyer's acquisition of tangible assets. For example, a seller that retains title to the asset being sold until the buyer has paid the purchase price in full (a retention-of-title seller), is extending credit terms to its buyer and is thereby financing the buyer's acquisition of that asset. The retention-of-title right is just one of several devices available to sellers. A seller may also transfer title to a buyer with a proviso that the buyer's title will be retroactively extinguished if it fails to pay the agreed purchase price (the sale is under a "resolutory condition"); or, a seller may transfer title to a buyer, but take a security right in the asset being sold.

9. Sellers comprise just one category of financiers that may provide credit to enable a person to acquire a tangible asset. Lenders, too, may provide credit to a buyer for the specific purpose of enabling that buyer to purchase assets from a seller. Because both sellers and lenders may provide credit to enable buyers to acquire tangible assets it is possible for more than one person to be claiming a right in a particular asset under acquisition financing transactions involving that asset.

10. Still another form of acquisition financing transaction may not even involve a contract of sale at all. A lessor that leases an asset to a lessee on terms that are economically equivalent to those of a sale on credit is likewise providing financing that enables the lessee to acquire use and enjoyment of the tangible asset as if it owned that asset, even if title never passes from the lessor to the lessee. As in the case of sellers, there are different ways in which lessors may structure the agreement so as to enable the lessee to acquire the economic equivalent of an ownership right in the leased asset. The Guide calls the right of the lessor in such cases a financial lease right.

11. Finally, a lender that provides credit to a lessee for the purpose of paying all payments as they come due under a lease may, depending on the terms of the credit, be an acquisition secured creditor entitled to claim an acquisition security right in the asset being leased. If the credit being extended actually enables the lessee to conclude the financial lease agreement with the lessor, the lender is financing the lessee's use (and notional acquisition) of that asset.

### (c) Outline of the chapter

12. This chapter discusses, in section A.2, the commercial background of contemporary acquisition financing transactions, and in section A.3, the various approaches to acquisition finance that have heretofore been adopted in different legal systems. Section A.4 sets out the key policy choices that confront States enacting legislation to govern the various types of acquisition financing transaction. The remainder of the chapter then reviews how the several components of a secured transactions regime discussed in other chapters of the Guide apply in the specific case of acquisition finance. It considers, in section A.5, the creation of such devices (their effectiveness as between the parties), in section A.6, the effectiveness of such devices as against third parties, in section A.7, priority of rights as against the rights of competing claimants, in section A.8, pre-default rights and obligations of the parties, in section A.9, enforcement, in section A.10, conflicts of laws, in section A.11, transition issues, and in section A.12, issues relating to the treatment of acquisition financing transactions in insolvency. The chapter concludes, in section B, with a series of specific recommendations.

## 2. Commercial background

### (a) General

13. The opening paragraphs of this chapter summarized a number of different ways for a buyer to finance its acquisition of tangible assets, such as raw materials, inventory and equipment. In this section, the commercial background of these various transactions and their actual operation in different States today are considered in greater detail. This discussion is meant to illustrate the broad range of transactions, involving a broad range of credit suppliers, which are being deployed to finance the acquisition of tangible assets, and to show the manner in which many transactions serve that purpose even though they are not denominated as such. The discussion is also meant to reveal that among the several States that use these different transactions there is a great diversity both in their scope and their effect. Finally, by briefly considering the advantages and the drawbacks of each of these traditional transactions as mechanisms, the discussion aims to provide a context for the particular approach to acquisition financing recommended in the Guide.

### (b) Unsecured and secured acquisition credit

14. An initial distinction to be drawn when considering the purchase and sale of tangible assets in a commercial setting is the distinction between cash sales and sales on credit. Sometimes buyers have sufficient liquidity that they may purchase equipment, raw materials and inventory on a cash basis. As a rule, however, commercial enterprises will acquire a substantial part of their raw materials, inventory and equipment on credit.

15. When tangible assets are purchased on credit, the buyer often obtains the credit on an unsecured basis. This normally occurs in one of the following two ways. First, a buyer might simply borrow an amount equal to the purchase price from a third party on an unsecured basis. For example, while the sale transaction is itself a cash transaction, it may effectively be financed by a general line of credit from the primary lender of the business. This method is simple, but the buyer's credit rating or reputation might limit availability of such credit or make the cost of such third-party credit prohibitively high.

16. Second, a buyer may agree with a seller to purchase the asset on credit terms that allow the buyer to make payment (perhaps in instalments) after the completion of the sale. Here the seller transfers possession and ownership of the asset to the buyer but is paid the purchase price at a later time, whether in a lump sum or through periodic instalment payments. This method is not really different from third-party finance except that the risk of non-payment is now on the seller rather than on a third-party financier. Many sellers are, however, unwilling to bear such an unsecured risk.

17. As a result, buyers often find that, as a practical matter, it is necessary to provide some form of security in order to acquire tangible assets on credit. The assets subject to the security right could well be other existing assets of the buyer. For example, a business could grant security over its factory or warehouse to secure repayment of a loan to be used to acquire equipment, inventory or raw materials. Typically, however, the most obvious asset in which security may be taken, and frequently the only such asset available to a buyer, is the asset actually being acquired.

18. Security for acquisition credit in the assets being acquired can arise in several different ways. For example, in some States, sellers have special rights arising by operation of law that enable them to cancel the sale and take back the asset sold if the buyer does not pay the purchase price within a certain period after delivery. Similarly, other States give sellers an automatic (non-consensual) right to claim a priority or preference in the distribution of proceeds of a sale (in execution) of the asset they have supplied. Often, however, the security claimed by an acquisition financier does not arise by operation of law, but is the result of an agreement between the seller or lender and the buyer.

19. As a matter of commercial practice, most acquisition credit results from an agreement between the buyer and the credit provider. As noted, these consensual acquisition financing transactions can take many forms and involve many different providers of credit. For example, the buyer may formally grant a security right in the asset to a third-party financier; or the buyer may formally grant such a security right to the seller; or the buyer and seller may agree to some other legal mechanism, which, although not in the form of a security right, is its economic equivalent. Historically, two such other mechanisms, both using ownership of the asset to secure payment, have played a central role in acquisition financing. These mechanisms are: (a) the seller's retention of title to the asset until the purchase price is paid; and (b) the use of a transaction documented as a lease. They are considered in turn, prior to a review of modern acquisition financing mechanisms available to both sellers and lenders.

### (c) Retention-of-title and similar transactions

20. A supplier of raw materials, inventory or equipment may wish to meet its customer's need for credit by supplying the asset to the customer under an agreement by which ownership does not pass to the buyer until the purchase price has been paid in full. In many cases the agreement is between the seller and the buyer without any intermediary. In some cases, however, the seller may sell the asset for cash to a finance institution or other lender, which may then sell the asset to the buyer under an agreement that provides for retention (or reservation) of ownership (or title) until full payment of the purchase price.

21. There are many types of agreement through which sellers may reserve ownership of the assets sold until full payment of the purchase price. The retention-of-title mechanism is very common. In this transaction the buyer's right to obtain title is conditional upon it paying the purchase price; until then, the seller is not required to transfer ownership to the buyer. While the buyer usually obtains immediate possession of the asset being purchased, ownership remains vested in the seller.

22. Retention-of-title arrangements are sometimes called "conditional sales". Generally, however, in transactions called conditional sales the sale itself is not conditional (that is, the actual sale agreement is not dependent on the occurrence of some future and uncertain event not related to the sale itself). Rather, under a conditional sale, it is the transfer of ownership to the buyer that is conditional. The seller reserves ownership of the asset sold until the purchase price has been paid in full or the buyer has complied with any other conditions prescribed in the sale agreement.

23. In addition to retention-of-title arrangements, there are a wide variety of other transactions in which a seller uses ownership to secure the unpaid purchase price of an asset it sells. For example, sometimes the reservation of a seller's ownership is structured as a sale with a term, and the transfer occurs only at the end of the stipulated term. In other transactions, possession of the asset is delivered to the purchaser under a "promise of sale" or an "option to purchase". Some States attempt to regulate these latter transactions by providing that a promise of sale accompanied by delivery is equivalent to a sale. Occasionally, a seller will actually transfer ownership to a buyer at the moment of sale, with a proviso that the buyer's title will be retroactively extinguished should it fail to pay the agreed purchase price according to stipulated terms.

24. In each of these cases, the key feature is that the agreement by the seller to postpone full payment (that is, to offer credit) is protected either by delaying the passing of title to the asset to the buyer or, less commonly, by transferring title to the buyer subject to the seller's right to regain title upon failure of the buyer to pay. As a general principle, the idea is that the buyer does not irrevocably acquire ownership of the asset being sold until the purchase price is fully paid.

25. Another form of transaction that has been used to serve the same economic function is a "consignment". The typical consignment structure is as follows. The consignor (the notional seller) retains ownership of tangible assets (typically inventory held for resale), but transfers possession to the consignee that is authorized to sell these assets to a third party. Upon such a sale the consignee is obliged to remit to the consignor an agreed amount. In the case of a true

consignment, the consignee has no absolute obligation to pay the agreed price; its obligation is either to pay the agreed price or to return the assets to the consignor (a right that a true buyer does not have). Thus, it is critical to examine the nature of the consignee's obligation: if it is to pay the price, but with payment deferred until the assets have been sold by the consignee, and the ownership of the assets is retained by the consignor to function as security (like a title-retention transaction), then it fits into the category of an acquisition financing transaction discussed in this chapter. Moreover, this will be the case even if ownership of the consigned assets never formally passes to the consignee because they are deemed to have been transferred directly from the consignor to the third party that bought from the consignee.

26. The most common of the above arrangements is the retention-of-title transaction. In some States, the basic transaction may be varied through various clauses that greatly expand its usefulness as an acquisition financing device. So, for example, the parties may be permitted to agree to an "all-monies" or "current-account" clause. Where such clauses are used, the seller retains ownership of the asset sold until all debts owing from the buyer to the seller have been discharged (and not just those arising from the particular contract of sale in question). This means, for example, that the seller will be able to assert its retained ownership rights in the asset sold against all other potential claimants until the unpaid purchase price for all other assets sold by the seller to that buyer has been paid in full.

27. In addition, in some States parties are permitted to add "products" clauses, in which the seller's ownership is extended to, or the seller is deemed to have a security right in, any products that are manufactured from the asset in which the seller retained ownership. Similarly, some States allow for "proceeds" (for the definition of "proceeds", see Introduction, section B, Terminology) clauses under which sellers may claim ownership or a security right in any proceeds generated by the sale of the assets in which they have retained ownership (for the treatment of proceeds in the case of ordinary security rights, see recommendations 19 and 20), although this is quite rare. In most of these States, however, the seller's transformed security right in the proceeds does not benefit from any special priority.

28. While there are great divergences in the extent to which States permit modification of the basic retention-of-title transaction, many adopt a traditional posture. In these States, the applicable law strictly limits the scope of the seller's retained ownership. The right may be claimed: (a) only upon the tangible asset sold (i.e. neither on proceeds of disposition, nor on replacement assets); (b) only so long as the asset remains in its original condition (i.e. unaltered by the manufacturing process); (c) only to secure the sale price of the particular asset; or (d) only when some combination of these three conditions is met.

29. Given the continued centrality of retention-of-title in many States today, for the purposes of this chapter, the expression "retention-of-title right" will be used generically to refer to the right of a supplier under all types of sales transaction where a buyer does not irrevocably acquire ownership of the asset being sold until the purchase price is fully paid (for the definition of "retention-of-title right", see Introduction, section B, Terminology).

### (d) Leases, hire-purchase transactions and financial leases

30. A supplier may also use the concept of a lease to enable its customers to acquire the use of an asset without having immediately to pay its purchase price. There is a wide variety of lease transactions that can be used as acquisition financing mechanisms. For example, a supplier of equipment may simply lease a piece of equipment to a business that takes possession of the equipment and makes monthly rental payments. In this agreement, the supplier necessarily retains ownership of the equipment (as lessor) and the lessee merely pays the rent as it falls due. While it is conceivable that such a lease arrangement could involve raw materials or inventory, parties will typically deploy these types of transaction to enable businesses to acquire the use of equipment (e.g. machinery, vehicles, computers, photocopiers, display racks, office furniture and hardware).

31. In many cases, the lease agreement is structured to achieve the functional equivalent of a title-retention sale. For example, the term of the lease may be for the useful life of equipment being sold so that at the end of the lease the lessee has enjoyed the equivalent benefit to having owned the equipment (whether or not ownership ever passes to the lessee and whether or not the lessee has an obligation to purchase the equipment at the end of the lease). Alternatively, the lease period could be for less than the useful life of the equipment but, at the end of the lease period, the lessee has the option to purchase the equipment at a nominal price or to extend the term for the balance of the useful life. In some States, this type of lease arrangement can only exist if the lessee is not obliged or even entitled to acquire the leased asset. In these States, it is the fact that ownership is never transferred that distinguishes a lease from a title-retention sale, but this transfer is not relevant to whether the transaction should be characterized as an acquisition financing transaction. Whenever the transaction is denominated as a lease, what really matters is whether the lessee is acquiring the use of the asset for at least most of its useful life in exchange for notional rental payments that represent the economic equivalent of its price under an instalment sale.

32. In a number of States, a similar result to a retention-of-title sale is achieved through devices called “hire-purchase transactions”. However, not all States use the expression to identify the same arrangement. For example, in some States, the hire-purchase arrangement commences with the lessee (hire-purchaser) selecting the equipment from the supplier (hire-seller) of the equipment. The lessee would then apply to a leasing company (usually a financial institution or an affiliate of one) to purchase the equipment from the supplier for cash and to lease it to the lessee (hire-purchaser). As with an ordinary financial lease, very often the lease comprises the useful life of the equipment and, at the end of the lease period, the lessee automatically acquires ownership or has the option to purchase the equipment at the end of the lease period for a nominal sum. In other States, the expression is used to cover transactions where a business leases the asset directly from the manufacturer and either automatically acquires ownership or has the option to purchase the equipment at the end of the lease period. For the purposes of this Guide, the expression is meant to cover any transaction that starts out as a lease arrangement, but contemplates that the lessee will acquire ownership of the asset at the end of the lease period.

33. Yet another acquisition financing transaction that takes the form of a lease is what many States label a “financial lease” or a “finance lease”. In these States,

financial leases are granted special tax advantages that have the economic effect of reducing the cost to the lessee. Whether the financial lease agreement is a two-party arrangement between lessor and lessee or a three-party arrangement, the transaction takes the form of a lease. Nonetheless, in each case, the economic reality is that the lessee is paying the notional purchase price for the equipment in instalments, while the lessor remains the owner until full payment is made. It is important to note, however, that the economic effects of such a transaction as an acquisition financing mechanism are not necessarily related to how a financial lease may be characterized for tax purposes. Consequently, a transaction may be a financing lease for secured transactions purposes although not one for tax purposes, or vice versa.

34. States that make general use of transactions in the form of leases as acquisition financing devices not only use different terms to describe these transactions, they also attach different consequences to their deployment. For example, in some States, the lessee is able to sell the leased asset and a good faith purchaser will be able to assert its rights against the lessor. In a few of these States, however, the lessor may be able to claim a right in the proceeds of the sale. In other States, the lessor may always be able to claim its right against an ostensible purchaser. Again, in some States, a lessor is able to reclaim the asset without the need for a judicial order if the lessee is in default. In other States, the lessor must first seek formal termination of the contract, and reclaim possession judicially. Finally, in some States, these transactions are strictly regulated by mandatory rules, while in others the specific leasing arrangements are tailored to the lessee's unique cash-flow requirements, the tax regime in a State and other needs of the lessor and lessee.

35. The above discussion suggests a great diversity in these lease transactions. Depending on the nature of the equipment at issue, lease periods may range from a few months to several years and items leased may range from high-value equipment, such as aircraft, to lower-value equipment, such as computers. In all cases, however, and whatever may be the definition given to a financial lease for tax or accounting purposes in any State, for the purposes of this chapter the expression "financial lease right" will be used generically to refer to all transactions that take the form of a lease but where the functional equivalent of ownership will be enjoyed by the lessee, regardless of whether formal title to the asset is ever transferred to the lessee (for the definition of "financial lease right", see Introduction, section B, Terminology).

### (e) Security rights of sellers

36. In many States today, several other legal devices are available to secure the performance of a buyer's payment obligations. As noted, in some cases, rights arise by operation of law. These non-consensual rights of sellers typically presuppose that ownership of the asset being sold has passed to the buyer. For example, in some States the seller of tangible assets is given a high-ranking "privilege" or a "preferential claim" on the money generated by a sale in execution of these assets. Whether the sale in execution is brought by the seller that has itself obtained a judgement against the buyer, by another judgement creditor of the buyer or by a secured creditor exercising a security right against the assets, the seller may claim its statutory priority. What is more, when it exists, this statutory preferential right (often called a vendor's privilege) is usually given a priority that is superior even to that of consensual secured creditors.

37. In some States, a seller also has a right to refuse to deliver tangible assets to a buyer that is not ready to pay the price at delivery. This right to refuse delivery usually also includes a right to interrupt the transport of assets by a carrier (the right of stoppage in transit). Occasionally, this right is projected forward as a reclamation right for a short period (e.g. 30 days) after delivery of the assets. None of these rights is particularly effective as a means for financing the acquisition of assets, however, since they invariably presuppose that the sale is made for cash and not on credit.

38. In addition to these rights attached to the contract of sale, traditionally sellers were also entitled to take a regular security right in the assets they sold. In many States, however, this was not an effective mechanism given the absence of a non-possessory security device. For example, a seller that transferred ownership of an asset title to a buyer would then have to keep or retake possession of that asset as a pledge. By contrast, other States have long permitted sellers to take non-possessory security, often in the form of a so called “chattel mortgage”. More recently a number of States that previously did not allow the “hypothecation of movable assets” have also modified their law to permit a seller to contract for a non-possessory security right in the assets it sells. This type of seller’s security right is usually available only in States that have also decided to permit lenders to take non-possessory security rights over tangible assets.

39. The development of non-possessory security rights in favour of a seller has usually been accompanied by another development. Sellers that take security are able, if they follow the appropriate procedure, to assert a priority over all other security rights in the asset being sold that are granted by the purchaser. In some States this special seller’s security right is called a “vendor’s hypothec”; in others it is called a “supplier’s lien” or “supplier’s charge”; in others it is called a “purchase-money security interest”. The name is of little consequence. What matters is that: (a) the seller’s non-possessory security right is identical in form to the non-possessory security right that may be taken by an ordinary lender; and (b) it is vested with certain special advantages. The seller that takes such a security right is usually able to claim a preferred priority position that allows it to outrank any other secured creditor that is asserting rights in the asset granted by the buyer.

### (f) Lender acquisition financing

40. In most modern economies, lenders provide a substantial segment of the acquisition finance market. Nonetheless, many States historically placed significant limitations on a lender’s capacity to provide acquisition financing. For example, it was often not possible for buyers to grant non-possessory security over assets they were in course of acquiring. Today, several States that permit lenders to take non-possessory security still do not also permit them to obtain a special priority when they provide acquisition credit. That is, even where the money advanced to the buyer was specifically intended to be used to purchase assets and was in fact used for that purpose, the lender that took security in those assets was considered to be an ordinary secured creditor subject to the ordinary priority rules governing security rights. As a result, in these States, a lender that provides acquisition financing for a particular asset will rank lower than a pre-existing secured lender with a security right in a buyer’s after-acquired assets of the type being purchased.

41. The only mechanism by which lenders could achieve the same preferred status as sellers and lessors was to acquire their rights. So, for example, where sellers retained ownership to secure the buyer's payment obligation, sometimes lenders would directly pay the purchase price to the seller and take an assignment of the seller's right to payment under the sale agreement, along with the seller's retention-of-title right. Similarly, in cases where the law enabled sellers to take a consensual security right with a special priority status in the asset being sold, the lender could purchase the seller's security right. Finally, in cases involving financial leases, the lender would sometimes purchase the lease contract (embracing the financial lease right) from the lessor. The particular form of transaction known in some countries as hire-purchase is a modern adaptation of this long-standing technique. While these lender's rights derived from sellers permit lenders to enter the acquisition finance market, they do not promote open competition among credit suppliers since: (a) either the consent of the seller will be required (often at a cost to the lender), or the lender will have to engage in multiple transactions (involving, for example, the purchase of and subrogation into the seller's rights) to achieve the desired outcome; and (b) the lender will be required to become the owner of the asset being acquired (a status it may not wish to assume).

42. Today, in order to promote competition for acquisition credit, some States permit lenders that provide acquisition financing to buyers of tangible assets to obtain, in their own name, a preferential security right in those assets. In other words, in these States it is now possible for lenders to accede directly to a priority status that was previously available to them only by purchasing the preferential right granted by a buyer to a seller. Not all lenders that provide money to a business that might ultimately be used to purchase tangible assets will be able to claim an acquisition security right. To be able to do so, the lender: (a) must advance the credit to enable the purchaser to acquire the assets; (b) the credit must actually be used for that purpose; and (c) the right can only be claimed in the assets thereby acquired.

43. Even though this special type of lender acquisition security right may be found in a number of States, the idea that a lender might be able directly to claim a preferential acquisition security right is not broadly accepted. Indeed, most States that permit sellers to secure the purchase price of the assets being sold through a distinct retention-of-title right do not permit lenders to claim preferential acquisition security rights. In these States, lenders as well as sellers may take non-possessory security, but typically, only sellers are permitted to claim a preferential acquisition security right, which they may do as an alternative to retaining ownership.

### 3. Approaches to financing the acquisition of tangible assets

#### (a) General

44. In the past, States have taken a wide variety of approaches to regulating acquisition financing transactions. As noted, however, protecting the rights of sellers was typically conceived as the central objective. Moreover, until recently, in many States it was not possible for a buyer to grant a non-possessory security right in tangible assets, even to a seller. For these two reasons, the retention-of-title technique developed as an everyday practice in civil law, common law and other systems. Sometimes States enacted legislation to acknowledge and regulate this acquisition financing technique. Most often, however, they failed to do so, with the

result that the contemporary law of acquisition finance in these States emerged from contractual practices that were later explicitly recognized and further elaborated by courts.

45. In order to appreciate the policy choices relating to acquisition financing now open to States, it is helpful to briefly consider three of the common approaches that have been taken to acquisition financing: (a) approaches that favour seller-based acquisition credit; (b) approaches that promote both seller- and lender-based acquisition credit as complementary but distinct mechanisms; and (c) approaches based on a fully integrated approach to acquisition finance that does not conceptually distinguish between sellers and lenders.

### (b) Approaches favouring seller-based acquisition financing

46. The development of the law of acquisition finance in many States focused on the protection of sellers. In no State did the legislature and courts set out to prevent financial institutions from providing acquisition financing. However, because this field was conceived as an adjunct to the law of sale, in these States retention-of-title and economically equivalent devices available uniquely to sellers, as opposed to financial institutions, were the main, if not exclusive, acquisition-financing devices that enabled buyers to obtain possession of the assets being purchased.

47. As an element of sales law that specifically touches the property aspects of the transaction, the character and effects of retention-of-title mechanisms vary widely from State to State. Many of these differences are products of history and the specific contractual practices that were adopted in response to (and frequently to overcome limitations imposed by) the legal rules in place in individual States. Thus, the law in this field has tended to develop in a haphazard way with novel contracts and additional terms to well-known types of agreement being invented piecemeal, as the need arose, to serve as proxies for a fully developed regime to govern acquisition financing transactions. As a result, the everyday contractual practices sometimes are not coherent with the legislative policy reflected by the current law in a State, and do not reflect the kinds of practices that business would adopt if the legal regime were designed to promote efficient secured credit

48. The approach that focuses on sellers as the principal source of acquisition finance is occasionally based on a policy decision to protect small- and medium-sized suppliers of tangible assets against large financial institutions. The approach acknowledges the importance of these manufacturers and distributors for the domestic economy and the dominant position of large institutions in credit markets. The policy decision to afford special treatment for sellers is often argued to rest on a number of assumptions. One is that suppliers have an interest in providing credit at low rates to increase the volume of their sales. Another is that the cost of such credit is affordable because many suppliers do not charge interest prior to default. A third is that, because there will usually be several suppliers seeking to sell tangible assets to any given buyer, competitive prices will be offered to buyers.

49. A State considering secured transactions law reform needs to evaluate these assumptions carefully. While some may be justified, others may not. For example, the fact that a supplier sells assets to a buyer under a retention-of-title arrangement does not necessarily mean that the seller's credit terms come at no cost to the buyer. The supplier itself has a cost of obtaining funds in order to extend these credit terms.

In cases where interest is not charged to the buyer until it fails to pay the purchase price for the goods in a timely manner, presumably the seller's cost of funds will be embedded in the price of the assets being sold and passed on to the buyer.

50. Even if a State interested in promoting the manufacture and supply of tangible assets wishes to encourage sellers to act as suppliers of credit, it need not, and should not, do so to such an extent that other parties are excluded from offering competitive acquisition financing. In the same way that competition among sellers normally reduces prices for buyers, competition among suppliers of credit normally reduces the cost of credit to borrowers and increases its availability. Fostering competition among all suppliers of credit will not only result in credit being available to the buyer at the most affordable rates, but is also likely to open up new sources of credit for buyers. This, in turn, will increase their capacity to purchase tangible assets without the need for sellers themselves to provide financing to all their potential buyers.

51. Legal barriers that prevent financiers other than sellers and lessors from directly extending acquisition credit to buyers, or that require these other financiers to extend credit only through the seller or lessor (by taking an assignment of the seller's retention-of-title right or the lessor's financial lease right), can be inefficient in other respects as well. Most importantly, treating acquisition financing simply as a matter of protecting the property rights of sellers and lessors can actually reduce the scope of the rights otherwise claimable by those sellers and lessors. Many modern secured transactions regimes offer secured creditors a number of rights that often have not, or not always, been available to sellers that use retention of title to secure their claims. These include, for example, an automatic right to claim a security right: (a) in any products that are manufactured from the assets in which a security right is granted; (b) in any proceeds generated by the sale of the encumbered assets; or (c) to use the security right to secure all debts that may be owing from the buyer to the seller.

### (c) Approaches promoting both seller- and lender-based acquisition financing

52. In part to expand the range of potential providers of acquisition financing to buyers, and in part to enable sellers to avail themselves of a full panoply of rights previously available to lenders that took security rights, many States today have redesigned their acquisition finance regime so as to promote both seller- and lender-based acquisition financing. Different approaches have been taken to achieve this outcome.

53. In some States that recognize special acquisition rights for sellers based on a reservation of ownership, retention-of-title sellers are now able to expand their rights by contract through the insertion of additional clauses into the agreement of sale. For example, some States permit retention-of-title sellers to insert a clause in the sale contract extending the seller's right into assets manufactured from the asset initially sold, or a clause (often referred to as an "all sums clause") allowing the retention of title to specific goods to stand as security for all obligations owed to the seller by the buyer. In rare cases, a State will also permit a retention-of-title seller to insert a clause in the sale contract extending the seller's right to receivables or other proceeds arising from the sale of the goods. Nonetheless, in most States that maintain special sellers' rights based on a reservation of ownership, only the simple retention-of-title is treated as a title device, while these other, more complex

retention-of-title arrangements are either not recognized or are treated as giving rise to security rights or fiduciary or other rights. It also bears notice that some States have also enhanced the rights of buyers under a retention-of-title arrangement, by recognizing a buyer's expectancy right in assets being acquired under a retention-of-title arrangement and permitting the buyer to grant a lower-ranking security right in the assets (or, in the case of goods to be acquired in the future, the expectancy of receiving such goods) in favour of another creditor.

54. A few States have reformed their secured transactions legislation to enable sellers to take preferential acquisition security rights, but still permit retention of title, financial leases and similar devices to co-exist as separate acquisition financing transactions. In these States, the various devices by which ownership is used to secure a buyer's obligation are, however, usually regulated by substantially the same set of rules as those applicable to a seller's acquisition security rights. Still other States maintain traditional sellers' acquisition financing rights alongside sellers' acquisition security rights, but also allow lenders to claim security rights in the assets being sold. To avoid the risk of imperfect coordination among various types of acquisition finance, these States often go further and require sellers to register a notice of a retention-of-title right in the security rights registry, and to follow the same procedures for enforcement that would apply to enforcement of a security right.

55. This last approach is based on a policy decision to provide, as far as possible, for the equal treatment of all transactions that are deployed to finance the acquisition of tangible assets. Attempting to create more or less equal opportunities for all credit providers, it is assumed, will enhance competition among them, thereby increasing the amount of credit available and reducing its cost to the benefit of both sellers and buyers. These types of modernized regime thus integrate sellers' and lessors' rights into the secured transactions regime, thereby facilitating financing on the security of the buyer's or lessee's expectancy, but at the same time, prevent other financiers to compete directly for a first-ranking acquisition financing right in the assets being purchased. In other words, while these States have adopted regimes that go a long way to achieving equal opportunities for the provision of acquisition credit, there is still a preferred priority status that is afforded to sellers over lenders that provide acquisition finance.

### (d) Approaches based on the fully integrated "purchase-money" security right concept

56. Some States have taken an additional step. Not only have they adopted an approach that permits and promotes both seller and lender acquisition credit, but they have also enacted regimes that treat all providers of acquisition financing equally. In these States, lenders can acquire the same preferential priority as sellers that take security rights in the assets they sell. For regulatory purposes, the various acquisition financing rights of owners (retention-of-title, financial leases and similar devices) are: (a) fully integrated into a single, functional security right; and (b) treated identically to the standard acquisition security rights available to sellers and lenders. In many States that have adopted this approach, these various acquisition security rights are all characterized as "purchase-money" security rights (for the definitions of "security right" and "acquisition security right", see Introduction, section B, Terminology).

57. Where the "purchase-money" security rights approach has been adopted, two important principles govern its application. The first is that a purchase-money security right, which in the Guide is referred to as an "acquisition security right", is a generic concept. That is, it is applicable to any transaction by which a financier provides credit to enable a buyer to purchase tangible assets and holds a right in the assets being purchased to secure repayment of that credit. The second is that a purchase-money security right is a species of security right. That is, except where the particular circumstances of acquisition financing require a special rule applicable only to such rights, all the rules applicable to security rights generally also apply to acquisition security rights.

58. The following are the main features of the acquisition security rights regime (using the terminology of the Guide) in States that have adopted the fully integrated, purchase-money security right approach:

(a) The right is available not only to suppliers of tangible assets, but also to other providers of acquisition financing, including lenders and financial lessors;

(b) The acquisition secured creditor is given, for secured transactions purposes, a security right, regardless of whether the creditor retains title to the assets being acquired;

(c) The buyer may offer a lower-ranking security right in the same assets to other creditors (and is thus able to utilize the full value of its rights in assets being acquired to obtain additional credit);

(d) Whether the agreement creating the acquisition security right is denominated as a security right, or is a retention-of-title right or a financial lease right, the acquisition secured creditor, like other secured creditors, normally has to register a notice of its security right in the general security rights registry;

(e) Once a notice of the security right is registered in the general security rights registry, the security right is effective against third parties;

(f) If the notice is registered within a short period of time after delivery of the assets to the buyer, the acquisition security right will normally have priority over competing claimants, including a creditor with a pre-existing security right in future (or after-acquired) assets of the buyer; and

(g) The acquisition secured creditor that is a seller or a financial lessor may enforce its rights, within or outside insolvency proceedings, in the same way as any other secured creditor and does not have, in addition, any title-based enforcement rights.

59. Over the past few decades, an increasing number of States have adopted this fully integrated approach to acquisition financing. This trend may also be seen at the international level. For example, the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment governs the effectiveness against third parties of retention-of-title and financial leases with separate but substantively similar rules to those regulating security rights. Accordingly, it extends the international registry contemplated by the Convention beyond security rights to retention-of-title and to financial leasing

arrangements. Moreover, under the United Nations Assignment Convention[1] the same rules apply to (a) security assignments; (b) assignments for security purposes; and (c) outright assignments (see article 2, subparagraph (a)), thus avoiding drawing a distinction between security rights and title-based devices. Indeed, article 22 of the Convention, which expressly covers various priority conflicts, includes a conflict between an assignee of receivables and a creditor of the assignor whose retention-of-title rights in tangible assets extend to the receivables from the sale of those assets. Finally, the same approach to acquisition financing is followed in the European Bank for Reconstruction and Development Model Law on Secured Transactions, the Organization of American States Model Inter-American Law on Secured Transactions and the Asian Development Bank's Guide to Movables Registries.

### 4. Key policy choices

#### (a) General

60. The Guide (see chapter I, section B, Basic approaches to regulating secured transactions) reviews the basic approaches to security that might be adopted by a State seeking to reform its secured transactions law. A key question addressed in that chapter is how to treat transactions that fulfil the economic function of a security device but are effectuated by utilizing title to an asset to secure the full payment of the financier's claim. This question arises in both non-insolvency and insolvency contexts.

61. Many States today continue to maintain a formal diversity of financing devices in all situations. That is, they recognize both security devices and devices such as fiduciary transfers of title and mortgages and sales with a right of redemption where a transfer of ownership of a borrower's assets is made to secure performance of an obligation. Other States maintain this formal diversity in non-insolvency situations, but under their insolvency regime characterize as security devices transactions where the right of ownership (or title) is used to secure payment of a creditor's claim. In these latter States, all transactions that fulfil the economic role of security are treated as functionally equivalent for insolvency purposes.

62. Other States have extended this "functional equivalence" approach to non-insolvency as well as insolvency contexts. The regimes in these States recognize the distinctive character of these various transactions involving title: sellers are still permitted to engage in retention-of-title or resolutory sale transactions, and lenders are still permitted to engage in secured transactions or sale transactions with a right of redemption. However, to ensure a proper coordination among these various transactions, and also to ensure, as far as possible, their equal treatment, these States subject all these transactions, however denominated, to a framework of rules that produces functionally equivalent outcomes.

63. Finally, some States carry this functional logic to its conclusion and adopt what might be called an "integrated" (or "unitary") approach. Their secured transactions regime characterizes as security all the various transactions fulfilling the economic function of security, regardless of their form, and explicitly denominates them as "security rights" (for the definition of "security right", see

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[1] United Nations publication, Sales No. E.04.V.14.

Introduction, section B, Terminology). That is, in these States, the regime does not simply maintain a diversity of mechanisms that are treated as "functionally equivalent". The regime recharacterizes all these mechanisms as security rights as long as they perform the economic function of a security right.

64. The Guide recommends that States adopt this last approach with respect to non-acquisition secured transactions. All transactions where rights in the grantor's assets, including ownership, are used to secure an ordinary repayment obligation by a borrower to a supplier of credit should be treated as security devices, and identified as such, in both insolvency and non-insolvency contexts (see recommendations 11 and 12). The Guide calls this the "integrated and functional" approach. As explained earlier (see paras. […] above), there are three main advantages of such an approach: (a) it more obviously promotes competition among credit providers based on price and thus is more likely to increase the availability of credit at lower cost; (b) it better enables legislative policy decisions to be made on grounds of comparative efficiency; and (c) because all transactions creating security rights are treated the same, the regime is easier to enact and apply.

65. When the obligation being secured is the payment of the purchase price of a tangible asset (that is, where an acquisition financing transaction is involved), a conceptually more complex issue is presented, since the parties involved are not all lenders. They are also sellers. In deciding whether to adopt the "integrated and functional" approach, therefore, States will have to determine whether: (a) the logic of secured transactions should override the logic of the law of sale and lease (or more particularly the logic of the law of ownership) when sellers and lessors use these transactions to secure the payment of the purchase price (or its economic equivalent) of tangible assets; or (b) the logic of sale and lease should override the logic of secured transactions as the primary organizing principle in these cases. In order to decide these issues, States must, first of all, consider whether the approach of providing functionally equivalent outcomes should be adopted as the most efficient way to reach the goal of substantial equality among acquisition financiers; and secondly, if so, States must consider whether the integrated approach should be adopted as the most efficient way to produce a framework of rules that achieves functional equivalence of outcomes.

### (b) Functional equivalence: a generic concept of acquisition financing

66. As noted above (see paras. […]), while closely linked, the principles of functionality and integration are independent. That discussion also notes that equal opportunity to provide credit is one of the primary objectives that States should seek to achieve when reforming their law of secured transactions generally.

67. There are good reasons of economic policy why States might wish to adopt the functionality principle in relation to acquisition financing. In market economies, creating equal opportunities for all credit providers will enhance competition among them, thereby increasing the amount of credit available and reducing its cost. There is no overriding reason of economic principle why the manufacturer or distributor of tangible assets should have a monopoly on providing credit to purchasers. Once it is accepted that financiers should be able to compete to offer buyers access to acquisition credit, the legal regime under which they do so should not create incentives for one or another sub-group of financiers. The most efficient way to ensure that competition for the provision of credit is based solely on the terms and

conditions offered by the financier is to establish legal rules that treat all of them in a way that produces functionally equivalent outcomes.

68. It follows that buyers should be permitted to seek out the best deal possible to satisfy their acquisition credit needs. They should have equal opportunity to negotiate, with any potential financier, the terms of the loan, the conditions of repayment, the interest to be charged, the events that would constitute a default and the scope of the security they provide. If the legal regime permits some financiers to obtain better security rights than others, this equality of opportunity to negotiate is compromised. In other words, from an economic perspective, there is nothing unique about acquisition financing that would induce a State to take an approach to credit competition different from that it adopts in relation to ordinary non-acquisition financing.

69. There are also reasons relating to the design of legal institutions why a State might wish to adopt the approach that aims at producing functionally equivalent outcomes. As noted above (see paras. 36-39), States have traditionally organized credit for buyers of tangible assets by providing specific entitlements for sellers (possibly on the assumption that sellers would provide most purchase-credit and most sales would be one-off transactions relating to individual items). Under such an assumption, the primary concern was simply to ensure that, if the buyer did not pay the purchase price, the seller could recover the sold asset quickly, efficiently and free of any third-party rights. That is, credit was simply an adjunct to the sale, and the seller's primary interest was to receive value for the asset provided to the buyer. Two developments over the past several decades have required States to rethink this position.

70. First, as economies expanded, the need for acquisition credit grew and sellers found that they often could not meet all the credit needs of their buyers. Especially where manufacturers, wholesalers and retailers were purchasing large quantities of raw material and inventory, it became increasingly common for banks, finance companies and other lenders to extend credit to buyers for the express purpose of enabling them to acquire these raw materials and inventory. Second, the types of equipment needed for manufacturing and distribution became increasingly sophisticated and expensive. Suppliers were frequently unable to provide the necessary financing to their prospective buyers. Moreover, often for tax reasons, buyers discovered that it was sometimes more economically advantageous to acquire needed equipment by a transaction documented as a lease rather than a purchase. Frequently, these lease transactions were structured as the economic equivalent of a sale upon credit.

71. In both of these cases, acquisition financing was being provided to a buyer (or notional buyer) by a person other than the direct seller of the assets. States were then confronted with having to decide whether continued reference to the seller's rights as the paradigmatic acquisition finance transaction was justifiable. The main reasons for concern lay in the fact that: (a) sellers were traditionally able to get a top-ranking secured right in the assets based on their ownership, but other acquisition financiers such as lenders typically were not; and (b) when the transaction was structured as a lease rather than a sale in which the seller transferred title to the buyer against a right to have the sale set aside for non-payment of the purchase price, it was generally not possible for the lessee to deploy the leased asset as collateral to secure other credit. These concerns led States to consider whether a

generic concept of an acquisition financing transaction might be a better way to organize this branch of secured transactions law.

72. Many States concluded that, even when they decided that sellers should continue to be able to protect their rights by retaining ownership of the assets sold until full payment by the buyer, the legal regime would be less uncertain and would generate less litigation if it did not draw purely formal distinctions between the rights available to different suppliers of acquisition credit. This led these States to simplify the design of the regime by adopting the approach that produces functionally equivalent outcomes: all transactions being deployed to finance the acquisition of tangible assets would be treated in essentially the same way regardless of their form and regardless of the legal status of the creditor (as seller, lessor or lender).

73. Consistent with the recommendation that States adopt the functionally-equivalent-outcome approach to non-acquisition secured transactions, in this chapter the Guide recommends that States adopt the functionally-equivalent-outcome approach in respect of all acquisition financing transactions, however denominated (see the statements of purpose in chapter XI, options A and B). That is, the Guide recommends that States enact regimes that achieve functionally equivalent outcomes, regardless of whether they also decide to adopt the fully integrated approach (see recommendation 174 for the unitary approach and recommendation 185 for the non-unitary approach).

### (c) Unitary and non-unitary approaches to functional equivalence

74. The second main policy choice that confronts States concerns the manner in which they design legislation to achieve functionally equivalent outcomes. Once again, the main objective is to ensure that, in so far as possible, the legal regime that brings about this functional equivalence is crafted in a manner that facilitates the broadest extension of credit at the lowest price. This type of efficiency in a legal regime can be achieved in one of two ways.

75. First, States may choose to collapse distinctions between various forms of acquisition financing transactions and adopt a single characterization of these devices. This is the policy that the Guide recommends for security rights generally. The method for achieving functionally equivalent outcomes is referred to as the "integrated" approach. Given the alternatives outlined in this chapter, the integrated approach will be characterized as the unitary approach to acquisition financing. All acquisition financing transactions under the unitary approach will give rise to "acquisition security rights" and all financiers will be considered as "acquisition secured creditors" (for the definitions of "acquisition security right" and "acquisition secured creditors", see Introduction, section B, Terminology).

76. Alternatively, States may choose to retain the form of existing acquisition financing transactions and the characterization that parties give to their agreement (e.g. as sale, lease or loan), subject to the court declaring that characterization to be a sham. In doing so, however, States will nonetheless be required to adjust and streamline their technical rules for each transaction so as to achieve functional equivalence across the whole regime The Guide refers to this method for regulating acquisition credit as the "non-unitary" approach. Acquisition financing transactions under the non-unitary approach will give rise either to "retention-of-title rights" and

"financial lease rights" where a title device is deployed, or to "acquisition security rights" in favour of acquisition secured creditors where a security right (whether in favour of a lender or a seller that transfers title to a buyer) is created (for the definitions of the terms mentioned in this paragraph, see Introduction, section B, Terminology).

77. Depending on law other than secured transactions law, the decision about which of these approaches to adopt could have significant consequences. For example, it might affect the rights of third parties both in and outside insolvency proceedings (the issues relating to insolvency are discussed in section A.12 below and in chapter XIV (The impact of insolvency on a security right)). In addition, having decided to adopt one or the other of these approaches, States will also have to decide exactly how to design the particular rules by which all aspects of acquisition financing transactions will be governed, and integrate them into the general law of sale and lease.

78. Three main consequences flow from a States' decision to adopt the unitary approach. First, all acquisition financing devices, regardless of their form, will be considered as security devices and subjected to the same rules that govern non-acquisition security rights. Second, a creditor's right in tangible assets under a retention-of-title sale, sale under resolutory condition, hire-purchase agreement, financial lease or similar transaction will be considered to be an acquisition security right and be regulated by the same rules that would govern an acquisition security right granted to a lender. Third, the buyer in such cases will be considered to have acquired ownership of the asset, regardless of whether the seller or lessor purports to retain title by contract.

79. States may take one of two paths to enacting the unitary approach in cases where sellers use retention of title or a financial lease. They may provide that the buyer becomes the owner for all purposes, with the result that States would explicitly have to amend other legislation (such as taxation statutes) if they desired that sellers in such transactions would be taxed as owners. Alternatively, they might provide that buyers become owners only for the purposes of secured transactions law and its related fields (debtor-creditor law and insolvency law in particular). It is important to note, however, that coherence of the regime requires States to take the same path in relation to acquisition financing transactions that they take in relation to non-acquisition financing transactions.

80. As the Guide adopts a unitary approach to non-acquisition financing, traditional lender transactions such as sales with a right of redemption, sales with a leaseback and fiduciary transfers of title are all considered to be ordinary security rights. Only in relation to seller transactions (and "seller-like" transactions such as financial leases) does the Guide contemplate the possibility of a non-unitary approach. That said, even when States adopt a non-unitary approach to acquisition financing transactions, they should design the regime to reflect the functional equivalence principle (see recommendation 185). For example, the regime should treat all the following suppliers of acquisition credit in a functionally equivalent manner: sellers that retain title; sellers that do not retain title but retain a right to cancel the sale: sellers that do not retain title but take a regular acquisition security right in the assets sold; lessors that retain title; and lenders that take a regular acquisition security right in the asset sold or leased.

81. In principle, States that adopt the non-unitary approach could achieve functional equivalence between the rights of sellers that retain title and financial lessor, on the one hand, and the rights of acquisition secured creditors, on the other, in one of two ways. They could: (a) model the rights accorded to retention-of-title and similar claimants on those given to acquisition secured creditors that are not sellers or lessors; or (b) they could model the rights of these other acquisition secured creditors on the rights already available to retention-of-title creditors. In the former case, all acquisition financiers would be treated the same (i.e. as acquisition secured creditors), but acquisition financiers that retain ownership would have slightly different rights from ordinary owners. In the latter case, all acquisition financiers and acquisition secured creditors would be treated the same (i.e. as owners) but acquisition secured creditors and non-acquisition secured creditors would be subject to slightly different rules. While formally these may appear to be equally viable options, in view of the overall objective to enable parties to obtain secured credit in a simple and efficient manner, there are several reasons why the former approach to achieving functional equivalence in a non-unitary regime should be preferred.

82. One may begin with the objective being sought. The question is what approach is the most likely to achieve the most transparent and lowest cost credit, regardless of the source of the credit. First, it would be quite complicated to design a set of rules that would treat lenders as owners (especially since lenders normally would have no expertise in selling or maintaining the assets they are financing). Second, even though these lenders would be characterized as owners, their ownership would not be identical to ordinary ownership since their enforcement rights would be adjusted to protect the rights of certain third parties that may have taken security in the buyer’s expectancy right. Third, it would be quite complicated to design a set of rules that distinguish between the accessory rights afforded to two classes of lenders, namely ordinary secured lenders and acquisition secured lenders. Fourth, it is much simpler to model the rights and obligations of a seller that benefits from an acquisition financing right (for example, in relation to the creation, effectiveness against third parties, priority over competing claimants and enforcement) on those of a seller or lender that benefits from an acquisition security right (an acquisition secured creditor). The reason is that this approach would enhance the overall coherence of the secured transactions regime, while enabling States to make adjustments necessary to maintain the coherence of their regime of ownership as reflected in the law of sale and lease. For these reasons, the Guide recommends that States choosing to adopt a non-unitary approach to acquisition financing transactions should seek to achieve functional equivalence by modelling retention-of-title rights and financial lease rights on acquisition security rights, rather than the reverse (see recommendation 185).

83. The Guide recommends that States adopt the unitary approach to achieving functional equivalence of acquisition finance to non-acquisition secured transactions. Given this general orientation, the Guide suggests that, to the extent that they have the opportunity to do so, States should also adopt the unitary approach to achieving functional equivalence among all acquisition financing mechanisms. Notwithstanding this suggestion, however, the Guide acknowledges that some States may feel the need to retain the form of title devices to govern the rights of sellers, financial lessors and other suppliers. For this reason, in each of the following subsections of this chapter (A.5-A.11), the relevant issues are examined as they

arise in contemporary legal systems. Each subsection concludes with a review of how the law of acquisition financing could be best reformed, if one or the other of these approaches (unitary or non-unitary) to achieving functional equivalence were adopted.

84. In section B, moreover, this chapter contains parallel recommendations presented as option A and option B. Option A presents recommendations about how States should design the detail of a unitary and functional approach to acquisition financing transactions. The Guide implicitly recommends this approach for States that are enacting legislation to govern the full range of secured transactions for the first time, although States with a comprehensive secured transactions regime can certainly benefit from this approach as well. Option B deals with how States that elect to retain a non-unitary approach should design rules governing acquisition financing through title devices and, in particular, retention-of-title and financial-lease transactions, as well as acquisition security rights, so that the economic advantages of functional equivalence may be equally achieved under a non-unitary approach.

### 5. Creation (effectiveness as between the parties)

85. The Guide discusses in the chapter on the creation of a security right (effectiveness as between the parties) the requirements for making a security right effective as between the parties (e.g. the grantor and the secured creditor). That chapter also uses the expression “creation” to characterize the requirements necessary to achieve effectiveness as between the parties. As explained in that chapter, the underlying policy is to make the requirements for achieving effectiveness between the parties as simple as possible (see paras. […]). The precise manner in which these requirements may be transposed to regulating the effectiveness of the rights flowing from an acquisition financing transaction as between the parties will depend on whether a State adopts the unitary or non-unitary approach.

86. In States that continue to recognize retention-of-title transactions and financial leases as distinct security devices, it is, moreover, not obvious that the word “creation” is the most appropriate one to describe how the seller under a retention-of-title transaction or the lessor under a financial lease “acquire” their rights. For example, the lessor’s ownership rights are not created by the contract of lease; the lessor is already the owner at the time it concludes the lease with the lessee. Likewise, the seller that retains ownership is not creating a new right in its favour; it is merely continuing to assert the right of ownership that it had prior to concluding the agreement with the buyer. Nonetheless, for ease of expression, the agreements under which a lessor and a seller may continue to assert their ownership against a lessee or buyer to whom they have granted possession of a tangible asset will sometimes be described as agreements “creating” the acquisition financing rights in question. It may be argued however that, in those States where the buyer under a retention-of-title agreement acquires an expectancy of ownership, a new type of bifurcated ownership is created, and that, consequently, it is appropriate to speak of the “creation” of a retention-of-title right that is not exactly traditional ownership.

87. States that do not treat all acquisition financing transactions in the same way impose widely varying requirements for making acquisition rights effective as

between the parties. To begin, the requirements imposed may vary within each State depending on the specific acquisition financing transaction (retention-of-title, financial lease, security right) in question. In addition, they can vary widely among different States even in respect of the same type of acquisition financing transaction. That is, not all States conceive retention-of-title rights and financial lease rights identically and, therefore, not all impose the same requirement for creating or reserving such a right.

88. As an acquisition financing right, retention of title is usually seen as a property right that arises as part of a contract of sale (such as a clause in one of the documents evidencing the sale). It follows that, in many States, the formal requirements for the creation of a retention-of-title right are those applicable to contracts of sale generally, with no particular additional formalities required. Hence, if a State accepts that a contract for the sale of tangible assets may be concluded orally, the clause of the agreement providing that the seller retains ownership until full payment of the purchase price might also be oral. In such cases, the seller's retention-of-title may be agreed to orally, or by reference to correspondence between the parties, a purchase order or an invoice with printed general terms and conditions. These documents may not even bear the signature of the buyer, but the buyer may implicitly accept the terms and conditions they set out through the taking of delivery of the assets and payment of part of the purchase price as indicated, for example, in the purchase order or invoice. In other States, even though a regular contract of sale may be concluded orally, a writing (even if minimal), a date certain, notarization, or even registration may be required for a retention-of-title clause in a contract of sale to be effective even as between the parties.

89. Credit providers that deploy financial leases, hire-purchase agreements and related transactions also retain ownership because of the nature of those contracts. The effectiveness of, for example, the lessor's right as between the parties will be dependent upon the parties complying with the ordinary formalities for third-party effectiveness applicable to the particular financial lease or hire-purchase agreement in question.

90. In most States, only the actual seller or financial lessor may benefit from a retention-of-title right or a financial lease right (as the case may be) and be required to follow the formalities associated therewith. Other suppliers of acquisition credit, such as lenders, may not directly obtain either a retention-of-title right or a financial lease right. Rather, to do so, they must receive an assignment of the contract of sale from the seller or an assignment of the contract of lease from the lessor. Thus, the formalities for effectiveness of the right claimed by a lender are, first, those applicable to the initial transaction with the buyer or lessee, and second, those applicable to an assignment of that type of contract. In many of these States, it is also possible for a lender that supplies acquisition credit to take a security right. Nonetheless, these States typically do not permit such lenders to acquire the preferred rights of a seller that retains title, or even (in States that permit sellers to take a non-possessory security right), the preferred position that is afforded to sellers that take a security right.

91. There are, however, several reasons why States might wish to permit lenders to accede to the status of acquisition secured creditors directly (that is, without having to take an assignment of a retention-of-title right or a financial lease right, or a seller's own acquisition security right). First, once it is accepted that a buyer may

grant security in its expectancy right, there is no reason in principle to restrict lenders to non-acquisition security transactions. Second, permitting lenders to provide acquisition financing will enhance competition for credit as among sellers, lessors and lenders (which should have a beneficial impact on the availability and the cost of credit). Third, without the possibility of direct, lender-provided acquisition financing, lenders that wish to advance credit to their debtors-buyers against the expectancy right in assets being acquired, will not have a preferred priority position as against other secured creditors on that expectancy right. They will simply rank according to the date their security became effective against third parties. That is, a later-in-time lender that wishes to advance credit specifically to enable a debtor to acquire tangible assets will (in the absence of a subordination agreement) always rank after a general financier that has previously made its security effective against third parties.

92. The various States that do not treat sales with a retention-of-title clause or financial leases as security rights also take differing approaches to the extension of these rights into other assets. In some States, if assets subject to retention of title are commingled with other assets, the retention-of-title right is extinguished (in a few States, by contrast, the retention-of-title continues to be effective as between the parties; in these States, by exception to general principles of property law, as long as similar assets are found in the hands of the buyer, the seller need not undertake any further formality to preserve its right of ownership). Similarly, in most States, the retention-of-title right cannot be extended to assets that are processed or manufactured into new products, while in a small number of other States, the retention-of-title is automatically preserved when the assets are manufactured into a new product. In some States that take the latter approach, the seller is entitled automatically to claim a security right in the new product, while in other States the seller simply becomes an ordinary secured creditor. Some States also permit lessors to continue to claim ownership of leased assets that have been slightly modified or, depending on the terms of the lease, in the proceeds of an authorized disposition. In these cases as well, no additional steps are typically required in order to preserve effectiveness of the security right as between the parties in the modified assets or the proceeds.

93. There is a greater similarity in the principles governing the requirements for effectiveness of acquisition security rights as between the parties among various States that have adopted a fully integrated approach. Indeed, almost no differences in these requirements may be found. Moreover, within each State, the formal requirements for making an acquisition security right effective as between the parties are identical, regardless of whether the financing is provided by a seller, a financial lessor, a lender, or any other person. In addition, because acquisition secured credit is treated simply as a special category of secured financing (that is, because an acquisition security right is a species of security right), these formal requirements will be the same relatively minimal formalities as those required for non-acquisition secured transactions (e.g. a written and signed agreement identifying the parties and reasonably describing the assets sold and their price; see recommendations 13-15). Finally, because the acquisition security right is a security right, it will be automatically preserved in manufactured assets and in proceeds of disposition (see recommendations 19-22).

94. The difference between the two approaches and among the specific legal systems described above rarely lies in a significant way in the writing requirement. That is, most of them would accept correspondence, an invoice, a purchase order or the like with general terms and conditions, whether they are in paper or electronic form. This is, moreover, the general position concerning a writing requirement that is recommended by the Guide (see recommendations 9 and 10). The difference seems to lie more in the requirement of a signature, which is often required for effectiveness as between the parties. Nonetheless, in some States the buyer's signature is not necessary as long as the retention-of-title seller, acquisition secured creditor or financial lessor is able to demonstrate by other evidence that the buyer or financial lessee has accepted the terms of the agreement. Such evidence could consist merely of the buyer's or financial lessee's acquisition and use of the assets without protest after having received the writing. Also, because so many transactions for the purchase of tangible assets are in fact well documented for other reasons, this issue rarely arises.

95. Under the unitary approach, the requirements for effectiveness as between the parties are the same as those applicable to non-acquisition security rights, and are identical regardless of the legal form (e.g. denominated security right, retention-of-title right, title resolution right, financial lease right) of the transaction (see recommendation 174).

96. If a non-unitary approach were adopted, States seeking to achieve the benefits of a regime that created equal competition for credit would have to develop a regime for creation of an acquisition security right that permits lenders to acquire the same preferred status that is given to retention-of-title sellers and financial lessors. To achieve this result, they would have to ensure that the rules governing effectiveness as between the parties would be functionally equivalent, regardless of the form of the acquisition financing transaction (see recommendation 185). In particular, the rules governing: (a) the capacity of parties to the contract; (b) the specific character and modalities of the obligation secured; (c) the objects upon which the acquisition financing right might be taken; (d) evidentiary obligations such as a writing and signature; and (e) the time of effectiveness of the agreement between the parties would have to be closely coordinated so as not to favour one type of acquisition financing transaction over another (see recommendation 185).

### 6. Effectiveness against third parties

#### (a) General

97. The Guide draws a distinction between effectiveness of a security right as between the grantor and the secured creditor and effectiveness of that right as against third parties (see the chapter on creation of a security right, paras. […], and the chapter on third-party effectiveness of a security right, paras. […]). The point has a particular importance in relation to acquisition financing rights since, depending on whether a unitary or non-unitary approach is followed, the distinction between these types of effectiveness may not actually exist.

98. Many States that do not treat retention-of-title rights and financial lease rights as security rights do not require these transactions to be registered. Nor do they require the seller or the lessor to take any other formal step beyond what is necessary to make the right effective between the parties in order to ensure its

effectiveness as against third parties. To the contrary, in these States, upon the seller and buyer concluding the agreement of sale with a retention-of-title clause, the seller's ownership right in the tangible assets that has been sold is effective as against all parties.

99. In some States, by contrast, registration of a retention-of-title right and a financial lease right is required (either generally or for particular types of tangible asset). In these States, it is often the case that registration is required only to make the seller's retention-of-title right effective as against third parties. Sometimes, however, no distinction is drawn between effectiveness of the retention-of-title right as between the parties and its effectiveness as against third parties. That is, in some States registration of retention-of-title right is viewed as a requirement for effectiveness even as between the parties. Not surprisingly, a similar diversity of approaches may also be found in relation to the formalities necessary to make a financial lease right effective against third parties.

100. Under all of these retention-of-title regimes, the seller that retains title retains ownership of the assets sold and delivered to the buyer. As a consequence, it will usually be the case that the buyer has no property rights in the assets being purchased until title passes, usually when the purchase price is paid in full. This means that, except in those legal systems in which the buyer has an ownership expectancy right to encumber, no other creditor of the buyer is able to claim rights in the tangible assets being purchased as long as the seller retains ownership. This would be the case even if another creditor provided credit to the buyer to purchase the asset and the value of the buyer's asset subject to the retention-of-title right was higher than the amount of the purchase price still owed to the seller. In such cases, the only asset of the buyer upon which another creditor could claim a security right would be an intangible asset (the right of the buyer to the value of the purchase price paid). An identical outcome would also result in the case of a financial lease. Unless the lease provides for a right of the lessee to buy the leased asset at the end of the lease and thus gives the lessee an ownership expectancy right that the lessee may encumber, the sole asset of the lessee upon which the lessee's creditors could claim security rights would be an intangible asset (the right of the lessee to the value of the rents paid).

101. States that do not recognize the right of a buyer that acquires assets under a retention-of-title transaction or a lessee under a financial lease to grant a security right in the assets purchased or leased either prevent or make it difficult for borrowers to use the full value of either the equity they may have acquired in their tangible assets subject to retention-of-title rights or financial lease rights. That is, the conceptual logic of a retention-of-title or a financial lease agreement disables the buyer from granting a non-possessory security right in the assets being acquired or leased. Interestingly, however, several of these same States permit a purchaser to grant multiple mortgages or hypothecs on immoveable assets, with priority based on time of registration, even when the immovable assets have been sold under a retention-of-title transaction and the purchase price has not yet been paid in full.

102. In States that now follow a fully integrated approach, retention of title and its economic equivalents are subject to registration of a notice in the general security rights registry (or to some other formality for making the right effective against third parties) in the same way as any other secured transactions. Under this approach, moreover, the right of the seller that retains ownership by contract, or of

the lessor that remains owner by virtue of the nature of the lease, is transformed into the right of an acquisition secured creditor. As a result, the buyer or lessee is able to use the equity it has in the assets being purchased or leased as security for further credit. That is, the right of the retention-of-title seller or financial lessor that is made effective against third parties is not a right of ownership. It is, rather a security right with the same third-party effectiveness as arises in the case of a seller that sells the tangible assets outright and takes its own security right in the assets sold.

103. Under the unitary approach, the requirements for third-party effectiveness (except in respect of the acquisition of consumer goods; see recommendation 175 and paras. 114-117 below) are the same as those applicable to non-acquisition security rights and are identical regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see recommendation 174).

104. If a non-unitary approach were adopted, States would have to ensure that no substantial differences in requirements for third-party effectiveness exist between the different kinds of acquisition financing transactions (see recommendations 185 and 189). A number of rules will have to be closely coordinated so as not to favour one form of transaction over another and, in particular, the rules governing: (a) the modalities by which third-party effectiveness can be achieved; (b) the timing of third-party effectiveness when requirements are met; and (c) the consequences of third-party effectiveness on the right of the buyer or lessee to grant rights in the assets. Specifically, in order to maximize the buyer's or lessee's capacity to benefit from the tangible assets being acquired in the non-unitary approach, States would have to provide that they have the power to grant a security right in the assets subject to the retention-of-title or financial lease right (see recommendation 187).

### (b) Third-party effectiveness of acquisition financing transactions generally

105. As noted in the chapter on the effectiveness of a security right against third parties, the general mechanism by which ordinary security rights may be effective against third parties is registration (see recommendation 32). As with ordinary security rights, registration is meant to provide a notice to third parties that such a right might exist and to serve as a basis for establishing priority between competing claimants. Generally, registration promotes credit market competition by providing information that enables financiers to better assess their risks.

106. For this reason, the Guide recommends that third-party effectiveness of all types of acquisition financing transaction (whether denominated as security rights, retention of title, financial leases or in some other manner) should usually be dependant on the registration of a notice in the general security rights registry. This notice would explicitly make mention of the fact that an acquisition security right is being claimed. Where the Guide also recommends other mechanisms to achieve third-party effectiveness for ordinary security rights (e.g. possession, registration in a specialized registry, notation on a title certificate), these mechanisms should also be available as alternative means to achieve third-party effectiveness of acquisition security rights (see recommendations 174 and 185).

107. Under the unitary approach, coordination of the registration of notices relating to acquisition and non-acquisition security rights in the general security rights registry will be necessary to promote certainty in the relative priority of competing

claimants. In particular, it will be necessary for creditors to indicate in their notices that they are claiming an acquisition security right.

108. Under the non-unitary approach, the rules governing the registration of a notice with respect to retention-of-title rights and financial lease rights will also have to be coordinated with the general rules relating to the registration of a notice with respect to security rights. Doing so requires either adjusting the former to cohere with the latter or, less plausibly, adjusting the latter to cohere with the former, and establishing a general security rights registry in which notices relating to all such rights can be registered. Together, these steps will ensure certainty in the relative priority of competing claimants that hold different types of acquisition financing rights (for further discussion of the mechanics of registration, see chapter VI, The registry system).

109. The principles that should govern what are called priority conflicts under the unitary approach, including priority conflicts where different methods for achieving third-party effectiveness have been used (see recommendations 176-182), and what are often questions of third-party effectiveness under the non-unitary approach (see recommendations 188-190, 192 and 194) are discussed below in section A.7.

### (c) Grace period for the registration of certain acquisition financing transactions

110. Many States historically did not require sellers to take further steps to make their rights effective as against third parties. Similarly, where a seller retained title, it was often not necessary to register the retention-of-title right (with very few exceptions). By contrast, and in keeping with the approach adopted by most States that have recently modernized their secured transactions law, the Guide recommends that registration (or some other step) be taken by sellers, financial lessors or lenders providing acquisition credit in order to achieve third-party effectiveness (see recommendations 174 and 189).

111. Where States require registration in the acquisition financing context, most seek to enhance the efficiency of the registration process by providing sellers and other suppliers of acquisition credit with a short "grace period" (e.g. 20 or 30 days) after delivery of the assets sold or leased to register a notice relating to the acquisition financing transaction in question. Such grace periods are found both in States that do not consider retention-of-title rights and financial lease rights to be security rights and in systems that consider all such rights to be acquisition security rights. Among other advantages, the use of the grace period permits sellers to deliver assets to the buyer without having to wait until they or any other supplier of acquisition credit registers a notice.

112. Under the unitary approach, if the notice is registered within the grace period, the right of an acquisition secured creditor in assets other than inventory has the same priority in relation to other claimants that it would have been able to assert had it registered at or before the time of delivery. This rule may be limited to assets other than inventory, as in the case of inventory, registration and notification of inventory financiers on record has to take place before delivery of the goods (see recommendation 176, alternatives A and B).

113. If a State were to adopt the non-unitary approach, the same rules relating to a grace period for registration and its effects should apply to all acquisition financing transactions, regardless of the legal form of the transaction (e.g. denominated

security rights, retention-of-title rights, title resolution rights, financial lease rights) (see recommendation 189, alternatives A and B).

**(d) Exceptions to registration for consumer transactions**

114. In some States where the registration of a notice relating to acquisition financing transactions would otherwise be required, an exception is made when those transactions relate to consumer goods (for the definition of this term, see Introduction, section B, Terminology). This means that the seller or other supplier of acquisition credit relating to tangible assets bought for the buyer's personal, household or family purposes is not burdened with a requirement to register; nor, as a rule, is the seller or credit supplier in these cases required to follow any of the other steps by which third-party effectiveness is normally achieved. Such transactions become effective against third parties at the same time that they become effective as between the parties. The idea is that in such cases the need to warn potential third-party financiers is less acute (unless consumers quickly resell the goods), especially where the consumer goods are of low value. In other legal systems that generally require registration, only relatively low-value consumer transactions are exempted from the requirement to register (e.g. consumer transactions up to a maximum of Euros 3,000 or its equivalent, or transactions that are subject to the jurisdiction of small-claims courts).

115. In both types of system, the significant market involving automobile finance credit to consumers is usually served by a system that requires registration not in the general security rights registry, but rather in a specialized registry, or that requires the notation of a notice on a title certificate. Moreover, it is important to note that, in States that create an exemption from registration for consumer goods, the exception applies only to consumer transactions. In other words, the exception does not apply to a particular type of asset as such (i.e. consumer goods), but rather only to a type of transaction relating to those assets. It is still necessary to register a notice to achieve third-party effectiveness in assets normally sold to consumers if those assets are being sold to a wholesaler or a retailer as inventory.

116. The exemption from registration does extend to equipment and inventory bought on credit for the buyer's personal, family or household purposes. Nonetheless, if a grace period were adopted for registering the notice of an acquisition financing transaction relating to equipment in the general security rights registry, that grace period may, in itself, serve as the equivalent of an exemption for short-term credit transactions fully paid within the grace period because, as a practical matter, the acquisition financier would not have to register before the expiry of that period. As for equipment-related acquisition financing transactions with longer repayment periods, and inventory-related transactions in general, an exemption may not be necessary if the acquisition financier could register a single notice in the secured transactions registry for a series of short-term transactions occurring over a longer period of time (e.g. five years) (see recommendations 182 and 196). These issues are fully discussed below in section A.7.

117. Under the unitary approach, the exemption from registration (or other method for achieving third-party effectiveness) for consumer transactions would apply regardless of whether the acquisition secured creditor were a seller, lessor or lender since they would all be claiming identical rights. Were a non-unitary approach to be adopted, the rules relating to the exemption from registration (or other method for

achieving third-party effectiveness) for transactions relating to consumer goods should produce the same consequences regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction (see recommendations 175 and 188).

### 7. Priority

#### (a) General

118. The Guide adopts the term priority to deal with competitions between all persons that may have rights in assets subject to a security right (for the definition of the terms "priority" and "competing claimant", see Introduction, section B, Terminology). The concept of priority thus includes competitions both with other creditors (secured creditors, other acquisition secured creditors, creditors that may avail themselves of a statutory preference and judgement creditors) and other claimants (including prior owners, buyers, lessees, licensees and the insolvency representative). Nevertheless, some States (and especially some States among those which do not consider retention-of-title rights and financial-lease rights to be acquisition security rights) adopt a more restrictive view of the notion of priority. Only competitions between creditors are considered to involve priority claims. Other potential conflicts (notably between prior owners and subsequent purchasers) are resolved by reference to the right of ownership. This said, however the competition between various potential claimants is characterized, the relative rights of each must be carefully specified.

#### (b) Priority position of providers of acquisition financing

119. The Guide recommends in the chapter on the creation of a security right (effectiveness as between the parties) that an ordinary security right may be taken in both present and future (or after-acquired) assets (see recommendation 13). It also recommends in the chapter on the priority of a security right that priority generally be determined by the date of registration of a notice with respect to a security right, even in relation to after-acquired assets (see recommendations 73 and 96). In order to promote the provision of new credit for the acquisition of additional assets, it is necessary to establish special rules applicable to competitions between retention-of-title sellers, financial lessors and acquisition secured creditors on the one hand, and pre-existing non-acquisition secured creditors holding rights in future assets of the grantor on the other.

120. In States that do not treat retention-of-title rights and financial lease rights as security rights, the relative priority of rights is decided by reference to the seller's or lessor's right of ownership. The retention-of-title seller or financial lessor effectively prevails with respect to the assets sold over all other competing claimants whose rights derive from the buyer or lessee (except certain bona fide buyers). Moreover, in most such systems, until the buyer or lessee acquires title to the assets (by fully paying the purchase price or, in certain cases, by making the last lease payment), none of the buyer's or lessee's other creditors (including secured creditors claiming a security right in after-acquired assets or creditors attempting to claim an acquisition security right in the assets) are able to claim rights in the assets being purchased or subject to the lease. At best, these secured creditors can claim a right in the value paid by the buyer or lessee, provided they have included that type of intangible asset in the description of the assets covered by their security right.

Similarly, judgement creditors and the insolvency administrator may claim the buyer's or lessee's rights, but unless the legal system permits the buyer or financial lessee to deal with its expectancy right, neither they nor secured creditors can seize the asset itself.

121. Finally, in most such States, there can never be a competition between lenders claiming as providers of acquisition credit and a retention-of-title seller or financial lessor. First, for reasons given, the buyer or lessee has no assets upon which the lender could actually claim an acquisition security right. Second, it is rarely the case that the lender could acquire the expectancy right of the buyer or lessee (for example, by taking a conditional assignment of the right subject to an obligation to retransfer it to the buyer or lessee when the loan is paid); and even if it could take such a right, the right would normally be seen as a type of pledge, or sale with a right of redemption, and not as a right arising in an acquisition financing transaction. Were a legal system to permit such transactions, the lender that acquired the ownership expectancy right would have a right that could be set up as against any other claimants asserting rights derived from the buyer or lessee (including buyers, secured creditors, judgement creditors and the insolvency representative), although not as against the retention-of-title seller or financial lessor. In other words, in these legal systems, the primary (if not the only) way in which a lender could acquire a preferred status as against other creditors and claimants would be to purchase the seller's or lessor's retention-of-title or financial lease right.

122. In States that follow the fully integrated approach, the priority rights of a seller or a lessor that provides acquisition financing are equally protected. Provided that the retention-of-title seller, financial lessor or similar title claimant registers a notice in the general security rights registry within a short grace period and, in the case of inventory, takes certain other steps discussed below, they will have priority over all other claimants (except certain bona fide buyers). Moreover, in these States, a lender that provides financing to enable a buyer to purchase assets will also be an acquisition secured creditor with priority over other claimants in the same manner as a seller or lessor. This means that, unlike the situation in States that do not follow the fully integrated approach, there can be more than one creditor claiming an acquisition security right. As a consequence, under the fully integrated approach, a further priority rule is necessary to deal with these cases. Invariably, these States provide that the seller that purports to retain title, the financial lessor, and the seller that transfers title but takes an ordinary acquisition security right will have priority over any other supplier of acquisition financing, even if that other financier (e.g. a bank or other lender) had made its acquisition security right effective against third parties before the seller or lessor did so. Thus, in States that follow the fully integrated approach, the seller and lessor are able to achieve the same preferred priority position in relation to all other claimants as the retention-of-title seller or finance lessor in a non-unitary system.

123. While rights under acquisition financing transactions will normally be made effective against third parties by registration in the general security rights registry, many States also contemplate other methods for achieving third-party effectiveness. In these States, one such method (i.e. possession by the secured creditor) will generally produce the same consequences as registration, and may be looked upon as an alternative to registration. As a result, should a supplier of acquisition financing such as a retention-of-title seller, a financial lessor or a seller that takes an

acquisition security right make its rights effective against third parties by possession within the stipulated grace period (given the purposes of acquisition financing, a highly implausible but theoretically possible situation), the general priority principle would be applicable. Where States also permit lenders to obtain acquisition security rights, an identical outcome would result (see recommendations 174 and 185).

124. Where the non-acquisition secured creditor makes its security right effective against third parties by registration in a specialized registry, the Guide recommends that the registration in the specialized registry will give the registering creditor priority over even prior registrations in the general security rights registry or third-party effectiveness achieved by a prior possession (see recommendation 74). In order to enhance the usefulness of the specialized registries, a similar rule should apply to suppliers of acquisition financing. They should not be able to obtain a preferred priority position simply by registration in the general security rights registry or possession within the grace period (see recommendation 177). By implication, it would follow that, as a general principle, and subject to any superseding law, an acquisition security right that is registered in the specialized registry would have priority over even a prior non-acquisition security right registered in that specialized registry. Nonetheless, in States that do not treat retention-of-title and financial lease rights as security rights, a certain nuance is necessary. In these States, the retention-of-title seller or financial lessor will be the party that is registered as owner in the specialized registry. No other creditor of the buyer or lessor can register a security right in that register, so the seller or lessor will achieve priority simply by virtue of its registered ownership right. Only in cases where the seller transfers title to the buyer and takes an acquisition security right would the principle relating to the priority of registration in specialized registries be applicable.

125. Under the unitary approach, all acquisition secured creditors are subject to the same priority regime and must take identical steps in order to assure their priority position. Having done so, they are entitled to claim priority over even pre-existing creditors that have non-acquisition security rights in the grantor's after-acquired (or future) assets. Because the acquisition security right overcomes the general rule that fixes priority based on the time of registration, this preferred position of an acquisition security right is often referred to as a "super-priority". In a competition between acquisition secured creditors that have all taken the necessary steps to make their rights effective against third parties, the time of registration will generally determine their relative priority under the same principles as apply to non-acquisition security rights (see recommendations 174 and 176). The only difference between different categories of acquisition secured creditors is that in a competition between a seller or a lessor and another creditor, all of whom are asserting an acquisition security right, the seller or lessor would always have priority, regardless of the respective dates of registration of their rights (see recommendation 178).

126. If the non-unitary approach were adopted to achieve functional equivalence, States would likely have to make slight adjustments to their existing regime. First, it would be necessary to permit providers of acquisition financing, other than retention-of-title sellers and financial lessors, to acquire the preferred priority status of sellers and lessors by taking an acquisition security right. In such cases, it is important that equivalent rules relating to the priority of the seller's or lessor's

rights are established regardless of the legal form (e.g. denominated security right, retention of title, title resolution, financial lease) of the transaction (see recommendations 184 and 185). Second, and concomitantly, in a competition between a retention-of-title seller, finance lessor or seller that takes an acquisition security right and a supplier of acquisition financing that is not a seller or lessor, it would be necessary to ensure that priority goes to the seller or lessor, regardless of the time at which these various acquisition financing rights and acquisition security rights were registered (see recommendation 195). This will follow as a matter of course in cases involving a seller that retains title or a financial lessor, but where the seller transfers title and takes an acquisition security right, it would be necessary to specify that the seller's acquisition security right will always have priority over any other acquisition security right.

### (c) Priority of acquisition financing rights in consumer goods

127. The general priority principles just noted establish a framework for organizing the rights of providers of acquisition financing where more than one of them may be in competition over the same tangible asset. However, not all tangible assets serve the same economic purpose and are subject to the same business dealings. Consequently, many States have drawn distinctions between types of such assets (notably, between equipment and inventory, but often between commercial assets and consumer goods as well) in the non-acquisition financing context. For example, in some States, different denominated security devices are available depending on the type of asset (an agricultural or commercial pledge for equipment, a transfer-of-property-in-stock and a floating charge for inventory). In States with fully integrated systems involving a generic concept of a security right, these different types of security device have disappeared. However, even in such States, the distinctions between different types of asset remain where acquisition security rights are an issue. Thus, it is instructive to examine how States have addressed acquisition financing in relation to different categories of asset.

128. The Guide recommends, by exception to the general rule, that the rights of providers of acquisition financing for consumer goods be effective as against third parties without registration in the general security rights registry or creditor possession (see recommendation 175 and 188). In other words, the relevant time for fixing effectiveness against third parties is the time when the agreement was effective between the seller, lessor or lender and the buyer, lessee or borrower, as the case may be. Consequently, the priority of a retention-of-title right or financial lease right over any non-acquisition security right created by the buyer, lessee or borrower is acquired automatically from the moment the right becomes effective as between the parties.

129. Under the unitary approach, providers of acquisition financing for consumer goods are able to claim a super-priority over non-acquisition secured creditors without the need to make the right effective against third parties by registration or possession (see recommendation 175).

130. States that adopt a non-unitary approach would have to provide equivalent rules giving priority to the seller's or lessor's rights over pre-existing rights in consumer goods regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. This priority could find its source either in the seller's or lessor's ownership, or in the case of a seller or

lender that takes an acquisition security right, in the general principle that applies to acquisition security rights in consumer goods (see recommendation 188).

### (d) Priority of acquisition financing rights in tangible assets other than inventory or consumer goods

131. As noted, in most States that do not consider retention-of-title and financial lease rights to be security rights, the issue of competition between providers of acquisition financing and between acquisition and non-acquisition financiers does not normally arise. Pre-existing non-acquisition secured creditors are rarely permitted to acquire rights in assets of which the grantor is not yet owner, and other lenders are generally not entitled to claim a special priority when they finance a buyer's acquisition of tangible assets. Moreover, even where it is possible to take a security right in the expectancy of ownership, that expectancy will only mature once the seller or lessor is fully paid. Only at this point can there be a real competition between claimants that derive their rights from the buyer or lessee (e.g. secured creditors, judgement creditors, the insolvency representative, buyers and lessees). Where, however, the seller itself takes an acquisition security right rather than retaining title and is in competition with a pre-existing non-acquisition security right, it is necessary to provide rules to determine when the seller's acquisition security right will have priority. Where equipment is involved, there is typically a single asset (or at most a relatively small number of individually identifiable assets) being sold or leased, and these assets are normally not meant to be resold in the short term. For this reason most States do not require retention-of-title sellers or financial lessors of equipment to take any further steps beyond those necessary to achieve third-party effectiveness as a condition of asserting their ownership.

132. In States that follow a fully integrated approach, the protection of the acquisition secured creditor's rights will have a common basis. Upon registration, before or within a grace period after delivery of the tangible assets to the grantor, the acquisition security right in the new equipment is given priority over pre-existing security rights in future equipment of the grantor. Moreover, in these States as well, because equipment financing usually involves either a single asset (or at most a relatively small number of individually identifiable assets) not normally meant to be resold in the short term, acquisition secured creditors are typically not required to take any further steps beyond those necessary to achieve third-party effectiveness as a condition of asserting their acquisition security right.

133. Under the unitary approach, all acquisition secured creditors of equipment are able to claim a super-priority over non-acquisition secured creditors for their acquisition security right, provided that they register a notice indicating that they are claiming such a right in the general secured rights registry within the stipulated grace period (see recommendation 176).

134. States that adopt the non-unitary approach would have to provide equivalent rules relating to the priority (or, in the terminology of the non-unitary approach, the third-party effectiveness) of the seller's or lessor's rights over pre-existing rights in future equipment regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. That is, even though the buyer or lessee is authorized to grant a security right in equipment over which it will only have an expectancy right until the purchase price is fully paid or the financial lease concludes, and even if that security right covers future or

after-acquired equipment and is made effective against third parties prior to the date of the sale, the retention-of-title seller (or similar acquisition financier) will have priority if it registers a notice of its rights within the same grace period given to an acquisition financier. Similarly, under this approach, a seller that transfers title but retains an acquisition security right, or a lender that supplies acquisition financing and takes an acquisition security right, will also have priority if it registers a notice within the indicated grace period (see recommendation 189).

**(e) Priority of acquisition financing rights in inventory**

135. Frequently, the competition between a supplier of acquisition financing and a non-acquisition security right arises in relation to inventory. In such cases, different policy considerations from those applicable to the acquisition of equipment are at issue. Unlike equipment financiers, inventory financiers typically extend credit in reliance upon a pool of existing or future inventory on a short-term basis and perhaps even on a daily basis. The pool of inventory may be constantly changing as some inventory is sold and new inventory is manufactured or acquired. In order to obtain a new inventory credit, the grantor usually would present the lender with invoices or certifications indicating the actual status of the inventory serving as security for the new credit.

136. In States that do not treat retention-of-title and financial lease rights as security rights, the relative priority (or third-party effectiveness) of rights is decided by reference to the seller’s or lessor’s right of ownership. It is implausible that inventory would be acquired under a financial lease, since the principal characteristic of inventory is that it will be sold. In cases involving retention-of-title rights, the position of a lender that finances the acquisition of inventory is especially precarious. Future advances will usually be made on the assumption that all new inventories are acquired under a retention-of-title transaction. It then becomes necessary for the creditor to determine what inventory has actually been fully paid. This has the effect of complicating a borrower’s efforts to obtain future advances secured by the pool of inventory. Nonetheless, the seller will have priority based on its ownership for inventory not yet paid for; only once the inventory is paid for by the buyer may other creditors assert security rights in that inventory.

137. In States that follow the fully integrated approach, the rights of the general inventory financier are more secure. Where the additional assets acquired by the grantor are inventory, the acquisition security right will have priority over a non-acquisition security right in future inventory if the registration of a notice in the general security rights registry is made prior to the delivery of the inventory to the grantor. In addition, in some States that follow the fully integrated approach, pre-existing inventory financiers that have registered their rights must be directly notified that a higher-ranking acquisition security right is being claimed in the new inventory being supplied. The reason for this rule is that it would not be efficient to require the non-acquisition inventory financier to search the general security rights registry every time it advanced credit in reliance upon a pool of ever-changing inventory. In order to avoid placing an undue burden on acquisition secured creditors, however, a single, general notification to pre-existing non-acquisition inventory financiers on record may be effective for all shipments to the same buyer occurring during a significant period of time (e.g. five years or the same period that registration lasts to make a security right effective against third parties). This would

mean that, once notification had been given to these pre-existing non-acquisition inventory financiers, it would not be necessary to give a new notification within the given time period for each of the multiple inventory transactions between the acquisition secured creditor and the party acquiring the inventory.

138. Under the unitary approach, the additional requirements usually found in States that now follow the fully integrated approach are adopted for acquisition security rights in inventory. That is, acquisition secured creditors are able to claim a super-priority over non-acquisition inventory financiers for their acquisition security right only if, prior to the delivery of the inventory to the grantor, they register a notice in the general security rights registry indicating that they are claiming an acquisition security right and they also notify in writing earlier registered non-acquisition financiers (see recommendation 176, alternative A). Under this approach, acquisition secured creditors do not have a grace period after the buyer obtains possession of the assets within which they may register a notice that they are claiming an acquisition security right.

139. While all States that have to date adopted the fully integrated approach take the above view, it is possible to imagine that no distinction should be drawn between inventory and assets other than inventory and consumer goods. If such were the case, the principles governing assets other than inventory would also apply to acquisition security rights in inventory. In order to maintain parallelism between the unitary and non-unitary approaches, the Guide presents these options in recommendations 176 and 189 as alternative A and alternative B.

140. If a State were to adopt a non-unitary approach, it would face a similar choice. Under alternative A in recommendation 189 of the non-unitary approach, equivalent rules relating to the priority of the seller's rights over pre-existing rights in future inventory should be established regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. That is, notwithstanding that the retention-of-title seller remains the owner of the assets delivered, the rules governing the sale of inventory should be adjusted so that the seller's title will have priority over pre-existing rights in future inventory only under the same conditions as its rights would have priority were they to arise under an acquisition security right taken by that seller (see recommendation 189). In other words, under alternative A, the retention-of-title seller or the seller or lender claiming an acquisition security right would be required, prior to delivery of the inventory to the buyer, to register a notice indicating that it is claiming an acquisition security right in the general security rights registry and also notify in writing earlier registered non-acquisition financiers.

141. Under alternative B in recommendation 189 of the non-unitary approach as recommended in the Guide, no distinction would be drawn between equipment and inventory. A retention-of-title seller, or a seller or lender claiming an acquisition security right in inventory, would only be required to register a notice indicating that it is claiming an acquisition security right in the general security rights registry either before, or within the indicated grace period after, the buyer obtains possession of the assets.

### (f) Multiple acquisition financing transactions

142. In many situations, a seller or other supplier of acquisition financing will provide financing to permit the acquisition of several assets. This could involve, for example, multiple sales with multiple deliveries of inventory or multiple sales of several pieces of equipment. In these situations, it is necessary to decide, as a matter of policy, whether the supplier of acquisition financing should benefit from its special priority rights over all equipment or inventory financed by it, without the need to identify the purchase price due under each particular sale. If so, the legal system in question is said to permit "cross-collateralization".

143. In most States that do not treat retention-of-title transactions and financial leases as security devices, the issue of cross-collateralization usually does not arise. In the normal case of a retention-of-title sale or similar title transaction, the contract of sale or lease applies only to the specific assets sold or leased under that contract. Thus, while the same agreement may cover multiple deliveries, it would not cover multiple sales. The priority claim of the seller or lessor as owner would relate to the specifics of each sale or lease. Some of these States do, however, permit the retention-of-title right to be enlarged by providing, for example, that the parties may agree to an "all monies" or "current account" clause where inventory is being sold. When such clauses are used, the seller retains ownership of the assets sold until all debts owing from the buyer to the seller have been discharged and not just those arising from the particular contract of sale in question. In some States, however, retention-of-title sales with "all monies" or "current account" clauses are often characterized by courts as security devices.

144. In States that follow the fully integrated approach, the usual rule is that the super-priority of acquisition security rights, at least in inventory, is not impaired by cross-collateralization. This means that the acquisition secured creditor may claim its preferred priority position in relation to the financed inventory without being obliged to specifically link any outstanding indebtedness to any particular sale or lease transaction. In such cases, the special priority right does not extend to other inventory or assets, the acquisition of which was not financed by that acquisition secured creditor.

145. Under the unitary approach, the goal is to permit a maximum of flexibility to acquisition secured creditors that provide financing for the acquisition of inventory, and to minimize the transactional paperwork associated with multiple acquisition transactions involving the same acquisition secured creditor. For this reason a single registration will be sufficient to cover multiple transactions and a single notice sent to creditors with security rights in after-acquired inventory of the type being supplied may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction (see recommendations 65, 175 and 176, alternative A, subparagraph (c), and alternative B, subparagraph (b)).

146. Under the non-unitary approach, because a contract of sale or lease normally applies only to the specific assets sold, it would be necessary to modify the rules relating to retention-of-title rights and financial lease rights so as to permit cross-collateralization. Moreover, under alternative A of recommendation 189 in relation to inventory, should a seller or any acquisition secured creditor that is not a seller take an acquisition security right in the assets, the seller or other financier should be

enabled to exercise a right of cross-collateralization in the same manner as under the unitary regime (see recommendation 190). Should alternative B of recommendation 189 be adopted, no notification of the retention-of-title, financial lease or acquisition security right would have to be sent in order for the supplier of acquisition finance to claim the preferred priority position.

### (g) Priority of rights of acquisition financing providers as against the rights of judgement creditors

147. In the chapter on the priority of a security right, the Guide recommends that the rights of creditors that obtain a judgement and take the steps necessary to acquire rights in a judgement debtor's assets will generally have priority over existing security rights for advances made after the existing secured creditors are informed of the judgement creditor's rights (see recommendation 81). When the competing right in question is a retention-of-title right, a financial lease right or an acquisition security right, a slightly different set of considerations, depending on the kind of tangible assets at issue, must be taken into account. For example, if the tangible assets are consumer goods, the provider of acquisition financing is not required to register or take possession of the assets in order to make its rights effective against third parties. Hence the retention-of-title seller or financial lessor as an owner upon conclusion of the transaction will not be in a priority competition with a judgement creditor since the judgement creditor cannot seize the assets of a person other than its debtor. Similarly, in the case of consumer goods, conflicts between an acquisition secured creditor and a judgement creditor will be rare since the consumer transaction will rarely involve future advances.

148. If the assets are inventory, the provider of acquisition financing must have possession of the assets or have registered its rights and notified already registered third parties of its rights prior to the buyer obtaining possession of the inventory. Hence the judgement creditor will always be on notice of the acquisition financier's or acquisition secured creditor's potential rights. However, in one case (that involving equipment), the provider of acquisition financing is given a grace period within which to register its rights. Nonetheless, as in the case of consumer goods, it is seldom the case that a provider of acquisition financing for equipment will be making future advances. This said, when a judgement creditor seeks to enforce its judgement against its debtor's assets, it should not generally be able to defeat the rights of a provider of acquisition financing that adds new value to the judgement debtor's estate.

149. If the unitary approach is adopted, it should be provided that, as long as an acquisition secured creditor makes its rights effective against third parties within the grace period, it will have priority even over judgement creditors that register their judgement during that grace period (see recommendation 179).

150. If the non-unitary approach is adopted, a similar protection should be afforded to retention-of-title sellers, financial lessors and acquisition secured creditors that register a notice of their acquisition security right within the indicated grace period (see recommendation 189). If alternative A were adopted, this principle would apply only in the case where the acquisition of equipment is being financed. By contrast, if alternative B were adopted, the grace period would also apply to inventory, and the recommendation would apply to cases where the acquisition of either equipment or inventory is being financed.

### (h) Priority of rights of acquisition financing providers in attachments to movable property and masses or products

151. The Guide recommends in the chapter on the priority of a security right that a security right in an attachment to movable assets that is made effective against third parties by registration in a specialized registry or by a notation on a title certificate has priority against a security right in the related assets that is registered subsequently in the general security rights registry (see recommendation 86). This recommendation rests on the fact that security rights that are effective against third parties remain effective even after the assets that they encumber have become attached to other assets. In such cases, if two or more security rights encumber the assets at the time of attachment, they would maintain their relative priority following attachment. In respect of a mass or product (or, in other words, commingled assets), the Guide recommends that the security rights continue into the mass or product, and if there are two or more, they retain their relative priority in the mass or product (see recommendation 87).

152. In both situations, however, it is also necessary to determine the relative priority of rights taken in the different tangible assets that are united by attachment or commingled. The Guide provides that the regular priority rules apply so that the time of registration in the general security rights registry would determine priority, unless one of the security rights was an acquisition security right. An acquisition security right taken in a part of commingled assets would have priority over an earlier registered non-acquisition security right (and presumably even an acquisition security right) granted by the same grantor in the whole mass or product (see recommendation 89). The Guide does not, however, take a position on whether an acquisition security right in an attachment should have priority over an earlier-registered non-acquisition (or even acquisition) security right granted by the same grantor in the tangible assets to which the attachment is attached.

153. In States that do not consider retention-of-title rights and financial lease rights as security rights, the general priority rules set out in the chapter on priority of a security right would not directly apply to acquisition financing. That chapter deals with situations where all forms of secured transaction are treated as security rights under the general unitary and functional approach. In the acquisition financing context, however, the relative rights of the parties depends on general rules of property law governing attachments. Normally, if the attached asset can be detached without damaging the assets to which it is attached, the retention-of-title seller would retain its ownership in the attachment. If the attachment could not be so removed, it is necessary to determine whether the attachment or the asset to which it is attached is the more valuable. If the tangible asset in which a seller has retained ownership is more valuable, the retention-of-title seller acquires ownership of the whole, subject only to an obligation to pay the value of the other asset. Conversely, if the tangible asset in which a seller has retained ownership is less valuable, the retention-of-title seller loses its ownership and merely has a claim against the new owner for the value of its former asset.

154. Under the unitary approach, acquisition secured creditors with rights in attachments or in assets that are commingled are generally able to claim a super-priority over non-acquisition secured creditors. That is, they will have priority over other secured creditors claiming a right in the attachment or in the tangible assets that are being commingled or processed. They will also have priority over

non-acquisition secured creditors of the assets to which the attachment is attached, at least in so far as the value of the attachment is concerned, and they will have priority over non-acquisition secured creditors with security over the entire mass or product (see recommendations 87-89).

155. If a State were to adopt the non-unitary approach, equivalent rules relating to the priority of the seller's rights over other rights in the attachment or the tangible assets to be commingled or processed should be established regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the transaction. In other words, notwithstanding that the retention-of-title seller of an attachment might lose its ownership upon attachment, the seller should be able to claim its priority either in the share of the mass or product that it sold, or upon the attachment that it sold. The exact mechanism by which the rules of attachments to movable assets would have to be adjusted depends on the detail of the law in each particular State that chooses to adopt the non-unitary approach.

### (i) Priority of rights of acquisition financing providers in attachments to immovable property

156. In the chapter on the priority of a security right, the Guide recommends that, after attachment, a security right in attachments to immovable property that is made effective against third parties under immovable property law has priority over a security right in those attachments made effective against third parties under the law relating to secured transactions. Conversely, if the security right in tangible assets is made effective against third parties before attachment and is registered in the immovable registry, it will have priority over subsequently registered security rights in the immovable property (see recommendations 84 and 85). The logic of these provisions should also apply to retention-of-title rights, financial lease rights and acquisition security rights.

157. The rights of a provider of acquisition financing in a tangible asset that will become an attachment should have priority over existing encumbrances on the immovable property provided that a notice of the right of the acquisition financing provider is registered in the immovable registry within a reasonable period after attachment. In this case, the person claiming an existing encumbrance on the immovable property made its advances on the basis of the value of the immovable property at the time of the advances and has no pre-existing expectation that the attachment would be available to satisfy its claim. In cases where the pre-existing encumbrance on the immovable property secures a loan that is intended to finance construction, this same assumption would not hold, and the rationale for preserving the preferred priority of the supplier of acquisition financing is less compelling.

158. Under the unitary approach, a single rule governing these cases is possible since the claim of the acquisition secured creditor will always be a security right (see recommendation 180). The acquisition secured creditor that takes the steps necessary to make its right effective against third parties will have priority, except as against a construction loan that is secured by the immovable property.

159. Should a State adopt the non-unitary approach, however, it will be necessary to adjust the rules relating to attachments to achieve a result that is functionally equivalent regardless of the form of the transaction. That is, it would be necessary to specify that the retention-of-title right and a financial lease right will normally

continue to be effective against third parties with existing rights in the immovable property, provided they register their rights in the immovable property registry within a short time after the asset becomes an attachment to the immovable property. By contrast, the retention-of-title seller and financial lessor would lose their priority to a construction financier even when the title to the assets being attached does not automatically pass to the owner of the immovable property (as would be the case for assets sold under retention of title or leased under a financial lease that is fully incorporated into the immovable property) (see recommendation 192). Likewise, a seller or lender with an acquisition security right will have priority should it re-register its rights in the immovable property registry within the same short period.

### (j) Acquisition financing priority in proceeds generally

160. In many cases, the supplier of acquisition financing knows that the buyer will resell the assets being acquired. This is obviously the case with inventory, but sometimes a manufacturer or other business enterprise will sell existing equipment in order to acquire upgraded equipment. As discussed in the chapter on the creation of a security right, an ordinary security right in tangible assets will normally extend into the proceeds of its disposition (see recommendation 19). In the case of acquisition financing, this extension of a security right into proceeds raises three distinct policy questions. The first relates to whether a similar extension into proceeds should be possible where the acquisition financing is by way of retention-of-title right or financial lease right. The second policy question is whether the special acquisition financing priority should also extend to proceeds. The third policy question is whether the rules for making such a claim should be the same regardless of whether equipment or inventory is being purchased.

161. While it is extremely rare, some States that do not treat retention-of-title rights and financial lease rights as security rights permit the seller or lessor to extend its ownership claim into proceeds generated by the sale of the assets when these proceeds are tangible assets of the same type as sold, for example, a vehicle received by the seller as a trade-in upon the purchase of a new vehicle. When the proceeds of disposition are in the form of receivables, the ownership right is invariably extinguished. Nonetheless, in some States, the retention-of-title right and financial lease right in intangible proceeds are converted into a security right, although, once again this is not the common practice.

162. The Guide takes the position that a retention-of-title right or a financial lease right should permit the seller or lessor to claim a right in proceeds and that, consistent with the position found in almost all of those few States which already extend the retention-of-title right into proceeds, this right should always be a security right and not a continuation of the ownership right (see recommendation 193). The second and third policy questions relating to proceeds of assets sold under retention-of-title or subject to a financial lease are discussed in the next two subsections.

### (k) Acquisition financing priority in proceeds of tangible assets other than inventory or consumer goods

163. In States that do not treat retention-of-title rights and financial lease rights as security rights, the issue of a seller or lessor claiming special rights in proceeds generated by the sale of equipment, while theoretically possible, usually does not

arise. This is because the law of sale or lease usually limits the seller's retained ownership right or the lessor's ownership only to the assets sold or leased. In cases of unauthorized disposition, the seller or lessor may be able to recover the asset in kind from the person to which it has been transferred. However, sometimes the assets cannot be found, even though assets or money received for their disposition can be identified. In addition, sometimes the seller or lessor permits the sale on condition that the seller's or lessor's title is extended to the proceeds of the assets in which the seller or lessor retained title. As noted, in these two situations, very few States permit the seller or lessor to claim ownership by real subrogation into the proceeds of the assets sold under a retention-of-title or financial lease transaction that are tangible assets of the same type. Where the contract is a sale, it is common to speak of the seller's rights as an "extended retention of title". In the majority of cases where such an extension is possible, however, the retention-of-title right or financial lease right is converted into a security right in the proceeds.

164. In some States that follow the fully integrated approach, the special priority of an acquisition security right extends only to the assets the acquisition of which is financed, while in other States the special priority may extend to its identifiable proceeds as well, at least in the case of transactions relating to equipment. Since the grantor does not usually acquire equipment with a view to immediate resale, there is little concern about prejudicing other secured creditors if the special priority of an acquisition security right in equipment is extended to the proceeds of its disposition. If the equipment becomes obsolete or is no longer needed by the grantor, and is later sold or otherwise disposed of by the grantor, the secured creditor will often be approached by the grantor for a release of the security right to enable the grantor to dispose of the equipment free of the security right. Absent that release, the disposition would be subject to the security right and it would be unlikely that a buyer or other transferee would pay full value to acquire the equipment. In exchange for the release, the secured creditor will typically control the payment of the proceeds, for example by requiring that the proceeds of the disposition be paid directly to the secured creditor for application to the secured obligations. Under these circumstances, it is unlikely that another creditor would rely upon a security right taken directly in an asset of the grantor that represents proceeds of the disposition of the equipment initially subject to an acquisition security right.

165. Under the unitary approach, the assumption is that equipment is not normally subject to ongoing turnover. The acquisition secured creditor's control over the disposition of the asset supports the conclusion that the special priority afforded to acquisition secured creditors should be extended into proceeds of disposition and products of the assets covered by the acquisition security right (see recommendation 181).

166. If a State adopts the non-unitary approach, the rules relating to the maintenance of a special priority in proceeds of equipment should produce the same consequences as against other claimants regardless of the legal form (e.g. denominated security right, retention-of-title right or financial lease right) of the acquisition financing transaction. That is, the special priority of the retention-of-title seller or lessor of equipment should be claimable in the proceeds of disposition, either by continuing the seller's or lessor's title in the proceeds or by giving the seller or lessor a replacement security right with the same priority claim as a seller or lender that took an acquisition security right. It would also be

necessary to provide for the third-party effectiveness of this replacement right in proceeds through rules relating to a registration of a notice or another method for achieving third-party effectiveness, as well as to provide that, in such cases, this right has the same priority against other claimants as if it were an acquisition security right taken by a seller or a lender (see recommendation 195).

**(l) Acquisition financing priority in proceeds of inventory**

167. The situation in relation to proceeds of inventory is different from that relating to proceeds of equipment for three reasons. First, inventory is expected to be sold in the ordinary course of business. Second, the proceeds of the sale of inventory will predominantly consist of receivables rather than some combination of a trade-in and receivables. That is, to take an example, it would not normally be the case that a seller of clothing or furniture would take back the purchaser's used clothing or furniture in partial payment of the purchase price. Third, it will often be the case that a pre-existing secured creditor, in extending working-capital credit to the grantor, will be advancing credit to the grantor on a periodic or even daily basis in reliance upon its superior security right in an ever-changing pool of existing and future receivables as original encumbered assets. It may not be possible or practical for the grantor to segregate the receivables that are the proceeds of the inventory subject to an acquisition financing right or an acquisition security right from other receivables over which a pre-existing creditor has taken a security right. Even if it were possible or practical for the grantor to segregate the proceeds generated by the disposition of inventory over which an acquisition financing right or an acquisition security right had been granted, it would have to do so in a way that was transparent to both financiers and that minimized monitoring by both financiers.

168. Without such a prompt segregation that is transparent to both financiers and that minimizes monitoring, there is a significant risk that the pre-existing secured creditor extending credit against receivables would mistakenly assume that it had a higher-ranking security right in all of the grantor's receivables. There is likewise a risk of a dispute between the pre-existing secured creditor and the retention-of-title seller, financial lessor or acquisition secured creditor as to which financier has priority in which proceeds. All of those risks and any concomitant monitoring costs may result in the withholding of credit or charging for the credit at a higher cost. If the priority of the provider of acquisition financing in the inventory does not extend to the proceeds, that provider of acquisition financing may itself withhold credit or offer credit only at a higher cost.

169. However, that risk may be ameliorated in a significant respect. For example, if the priority of the acquisition financing right or acquisition security right in the inventory does not extend to the receivables proceeds, a pre-existing secured creditor with a prior security right in future receivables of the grantor will be more likely to extend credit to the grantor in reliance upon its higher-ranking security right in the receivables to enable the grantor to pay for the inventory acquired by the grantor. The amount of the advance by the pre-existing secured creditor should be sufficient for the grantor to pay the purchase price to the seller of the inventory. This is because usually advance rates against receivables generally are much higher than those against inventory and because the amount of the receivables reflects a resale price for the purchase of the inventory well in excess of the cost of the

inventory to the seller. Thus, there is a greater likelihood that the purchase price will be paid on a timely basis.

170. Under the unitary approach, the complexity of determining what receivables arise from the disposition of assets in which an acquisition security right exists, and the widespread use of receivables as assets subject to a separate security right, are cogent reasons why the special priority afforded to acquisition security rights in inventory should be limited to proceeds of disposition other than receivables and other payment rights (e.g. negotiable instruments, rights to payment of funds credited to a bank account, and rights to receive the proceeds under an independent undertaking; see recommendation 182).

171. While all States that have to date adopted the fully integrated approach take the above-mentioned view, it is possible to imagine that no distinction should be drawn between proceeds of inventory and proceeds of assets other than inventory and consumer goods. If such were the case, the principles governing assets other than inventory would also apply to acquisition security rights in inventory. However, because the right in proceeds would also extend to receivables and other payment rights, the security right in proceeds would not have the special priority of an acquisition security right but would only have priority according to the general rules applicable to ordinary security rights. In order to maintain parallelism between the unitary and non-unitary approaches, the Guide presents these options in recommendations 182 and 196 as alternative A and alternative B.

172. Should a State adopt the non-unitary approach as recommended in the Guide, it would face the same choice. Under alternative A, the special priority given to acquisition financiers and acquisition secured creditors should not be extended to proceeds of disposition in the form of receivables and other payment rights regardless of the legal form of the acquisition financing transaction (e.g. denominated security right, retention-of-title right or financial lease right). In particular, the special priority of the retention-of-title seller of inventory should be claimable only in other tangible assets, and not in proceeds of disposition of that inventory that take the form of receivables and other payment rights (see recommendation 196, alternative A). By contrast, under alternative B, the retention-of-title seller, financial lessor or acquisition secured creditor would be able to claim a security right in the proceeds of disposition of that inventory, including proceeds that take the form of receivables and other payment rights, but it would only have priority according to the general rules.

[*Note to the Commission: The Commission may wish to note that the alternatives in recommendations 182 and 196 are presented in a note as the matter has not yet been considered by the Commission. Paragraphs 167-172 may need to be revised to reflect the final decision of the Commission on this matter.*]

### (m) Priority as between rights of competing providers of acquisition financing

173. In the various priority conflicts already described in this section, the competing claimants are asserting different rights in tangible assets. That is, the conflicts are between the rights of a retention-of-title seller, financial lessor or an acquisition secured creditor and mainly a non-acquisition secured creditor. In a few cases, however, the competition could be between two claimants, each of whom is asserting rights arising from an acquisition financing transaction. The main

circumstance in which, depending on the applicable law of a given State, this may occur is when a lender provides credit to a buyer in order to make a down payment, and the seller also offers credit terms to the purchaser for the remainder of the purchase price.

174. In States that do not treat retention-of-title rights and financial lease rights as security rights, the relative priority of claims is decided by reference to the seller's or lessor's right of ownership. Unless that system permits other creditors to take a security right in the expectancy right of the buyer, a competition between owners and secured creditors would not arise. Further, even if it were possible for a creditor to take a security right in a buyer's or lessee's expectancy right, that expectancy right will only mature once the seller or lessor is fully paid. In other words, in most States with such systems, there can never be a direct competition between a lender claiming rights under an acquisition financing transaction and a seller or lessor. The only way that a lender could acquire an acquisition financing right would be to obtain an assignment of the secured obligation from the retention-of-title seller or the financial lessor.

175. Furthermore, in States that do not treat retention-of-title rights and financial lease rights as security rights, it is often possible for a seller (although not a lessor) to transfer title to the asset being sold to the buyer and take back a security right. Sometimes these seller's rights arise by operation of law (e.g. the vendor's privilege), but sometimes they arise from an agreement between the seller and the buyer. In such cases, the buyer may well grant competing security rights in the asset being acquired. These rights will usually be security rights granted after the asset has been purchased. Less commonly, in most of these States, they might also arise beforehand, by virtue of a security right covering present and future assets. Nonetheless, even when the lender advances credit to enable a buyer to acquire the assets, the security it takes in those assets is invariably considered to be an ordinary security right. That is, in most States that do not treat retention-of-title rights or financial lease rights as security rights, it is not possible for lenders to directly accede to the preferred priority position that is given to a seller that transfers ownership to a buyer and takes back an acquisition security right. Once again, in most such States, the only way that a lender could acquire the preferred priority afforded to an acquisition security right would be to obtain an assignment of the secured obligation from the seller that has taken such a security right for itself.

176. In States that follow the fully integrated approach, the priority rights of a seller and a lessor are protected because the rights they would otherwise claim as owners are characterized as acquisition security rights and are given the same preferred priority position through the concept of the "purchase-money security interest" special priority. Such a preferred priority position is also afforded to sellers that simply take a security right in the assets being supplied and to lenders that advance money to borrowers so as to enable them to purchase tangible assets. In other words, under the fully integrated approach, it is possible to have a genuine conflict between more than one acquisition security right. The normal priority rule in such States is that, as between competing security rights of the same type, the first to register, or if another method for achieving third-party effectiveness is used the first to achieve third-party effectiveness, would prevail. Thus, for example, as between two lenders that may both claim an acquisition security right, the first to register will have priority. It may be, however, that a seller that claims an acquisition security right

registers its notice after a lender that has also provided acquisition financing. In this one case, these systems override the usual priority rule so as to protect the prior owner of the asset being sold. The seller that makes its acquisition security right effective against third parties will have priority even over lenders with pre-existing acquisition security rights.

177. Under the unitary approach, in any competition between a seller that is claiming an acquisition security right and a lender that is also claiming an acquisition security right, the seller's acquisition security right will have priority regardless of the respective dates that these acquisition security rights were made effective against third parties (see recommendation 178). In addition, in a competition between two acquisition security rights taken by lenders, the normal priority rules apply. That is, the time at which the right became effective against third parties will determine the relative priority of the two rights.

178. In States that choose to adopt the non-unitary approach, an initial policy decision is whether to permit financiers other than sellers or lessors to take security rights in assets being acquired by their borrower that can achieve the preferred priority status of an acquisition security right. If not, there will never be a competition between two or more acquisition financiers. The Guide recommends that, even when assets are sold under a retention-of-title arrangement or are subject to a financial lease, the buyer may grant security over the asset being sold or leased (see recommendation 187). Moreover, it also recommends that lenders that provide acquisition financing to buyers be permitted to claim an acquisition security right (see recommendations 184 and 185). As a result, States that adopt the non-unitary approach will also face a possible competition between providers of acquisition financing. Should the competition be between a retention-of-title seller or a financial lessor and a lender, the seller or lessor will always have priority as a consequence of its right of ownership. Should the competition be between a seller that claims an acquisition security right and a lender claiming such a right, States will have to adopt a rule that provides for the priority of the seller's or lessor's acquisition security right, whatever their respective dates of effectiveness against third parties. Moreover, States will also be required to specify that, as between acquisition security taken by financiers other than sellers or lessors, the priority of these rights will be determined by the time they became effective against third parties, regardless of the form of the transaction.

[*Note to the Commission: The Commission may wish to consider whether a recommendation along the lines of recommendation 178 (unitary approach) should be included also in the non-unitary approach section of chapter XI.*]

### (n) Effect of the failure of a provider of acquisition financing to make its acquisition rights effective against third parties

179. Normally, a retention-of-title seller, a financial lessor or a seller or lender that takes a security right in assets being acquired by a buyer will ensure that it has taken all the steps necessary to make its rights effective as against third parties. In the case of a retention-of-title right or a financial lease right this means following one of the methods for achieving third-party effectiveness, and in the case where this is accomplished through registration in the general security rights register, doing so within the indicated time (see recommendation 189). In the case of an acquisition security right, whether under the unitary or non-unitary approach, the secured

creditor must take the steps necessary to achieve third-party effectiveness, and if that step is registration in the general security rights registry, doing so within the indicated time (see recommendations 176 and 189).

180. A failure to achieve third-party effectiveness within the applicable time period has significant consequences for all providers of acquisition financing. Should an acquisition secured creditor fail to register in a timely fashion (see para. 122 above), this does not mean that it loses its security right. Provided that it has taken the steps necessary to achieve third-party effectiveness after the expiry of the grace period, the secured creditor claiming an acquisition security right will not be able to assert the special priority associated with that right. At this point, it will simply be an ordinary secured creditor subject to the general priority rules applicable to security rights.

181. The situation is slightly different where a retention-of-title seller or a financial lessor fails to make its rights effective against third parties in a timely way. In these cases, the seller or lessor loses the benefit of its ownership, and in so far as the rights of third parties are concerned, title to the asset being sold or leased is transferred to the buyer or lessee. The complete loss of rights is a severe consequence to attach to a failure to take the steps necessary to achieve third-party effectiveness. In order to palliate these consequences and to parallel the result reached in respect of acquisition security rights, it is necessary to convert the seller's or lessor's right into an ordinary security right, subject to the general priority rules applicable to security rights (see recommendation 193).

182. A similar conclusion should be reached in other cases where a retention-of-title seller or a financial lessor is deprived of its rights of ownership. For example, where the seller of an asset that becomes an attachment to immovable property is not made effective against third parties after the attachment in a timely way, the seller or lessor loses its ownership right. Once third-party effectiveness is achieved, however, the seller or lessor may claim an ordinary security right.

[*Note to the Commission: The Commission may wish to consider whether a recommendation along the lines of recommendation 193 should be added to address the point made in paragraph 182*.]

### 8. Pre-default rights and obligations of the parties

183. As noted in the chapter on the rights and obligations of the parties, in most States there are very few mandatory rules setting out pre-default rights and obligations of the parties. The vast majority of applicable rules and principles are suppletive (non-mandatory) and may be freely derogated from by the parties. In addition, for the most part the pre-default rights and obligations of the parties will depend on how any particular State conceives the legal nature of the transaction by which acquisition financing is provided.

184. In States that do not treat retention-of-title rights and financial lease rights as security rights, the regime governing pre-default rights and obligations applicable to non-acquisition security rights cannot be simply transposed to acquisition financing rights. The rules applicable to acquisition security rights (whether taken by a seller or by a lender) will mirror those applicable to non-acquisition security rights. However, where a title device (retention-of-title, financial lease or similar

transaction) is at issue, it will be necessary to adjust the manner by which these rules are expressed.

185. As the objective is to achieve functional equivalence among all acquisition financing transactions, this will often require reversing the default presumptions about the prerogatives of ownership. That is, normally it is the owner (the retention-of-title seller or the financial lessor) that has the right to use an asset and to collect the civil and natural fruits it produces. Normally it is the owner that bears the risk of loss and, therefore, has the primary obligation to care for the asset, maintain it, keep it in good repair and insure it; and normally, it is the owner that has the right to further encumber the asset and to dispose of it. In order to achieve the desired functionally equivalent results, therefore, these States will have to provide a mix of mandatory and non-mandatory rules vesting each of these prerogatives and these obligations in the buyer and not in the seller or lessor.

186. States that adopt the unitary approach need not attend directly to this issue, since an acquisition security right is simply a species of security right. As such, it would only be necessary to apply the regular rules about pre-default rights and obligations to all acquisition financing transactions, regardless of the form of the transaction in question. That is, there is no reason to assume that obligations relating to use, the obligation to protect the value of the secured assets, the collection of civil and natural fruits, the right to encumber, or the right to dispose should be any different simply because the security right at issue is an acquisition security right. If acquisition secured creditors and grantors wish to provide for a different allocation of rights and obligations, they should be permitted to do so within exactly the same framework as applicable to non-acquisition secured rights (see recommendations 107-110).

187. Should a State adopt the non-unitary approach, however, the specific pre-default rights and obligations of the parties will have to be spelled out in greater detail in order to achieve functional equivalence. In relation to retention-of-title sellers and financial lessors, these rules will often have to be enacted as exceptions to the regular regime of ownership rights. As noted in the chapter on the rights and obligations of the parties, most of the pre-default rules will not be mandatory. However, as the non-mandatory default regime should establish a set of terms about pre-default rights and obligations that the legislature believes the parties would choose to most efficiently achieve the purpose of a security device, States that do adopt the non-unitary approach should ensure the enactment of non-mandatory rules that mirror those it enacts to govern acquisition security rights taken by sellers or lenders. So doing would have the additional advantage of clearly specifying the right of the buyer to grant security over its expectancy right, and confirming the buyer's right to use, transform or process the assets in a reasonable manner consistent with its nature and purpose (see recommendations 107-110).

### 9. Enforcement

188. The discussion in the chapter on the enforcement of a security right illustrates that in most legal systems the rules relating to enforcement of post-default rights flow directly from the manner in which that legal system characterizes the substantive right in question. For example, many systems consider certain rights to be "property rights" and provide for special remedies to ensure their effective enforcement. Other rights are characterized as "personal rights" and are usually

enforced by bringing an ordinary legal action against a person. In such systems, both the right of ownership and security rights in tangible assets are seen as a species of "property right" enforceable through an *in rem* action (an "action against the asset"). Although the specifics of enforcement of property rights through *in rem* actions can vary greatly depending on the particular property right enforced and the specific configuration of a State's procedural laws, for the most part these rules governing enforcement of post-default rights are mandatory. As such, they cannot be derogated from by the parties to an acquisition financing transaction.

189. In States that do not treat retention-of-title rights and financial lease rights as security rights, the procedure for enforcement of the seller's or the lessor's rights will normally be that open to any person that claims ownership in tangible assets. So, for example, upon default by the buyer, the retention-of-title seller may terminate the sale agreement and demand return of the assets as an owner. In that event and subject to any term of the agreement to the contrary, the seller is normally also required to refund at least a part of the price paid by the buyer. The amount of the payment due by the seller is often calculated by requiring disgorgement of all money received from the buyer, minus the rental value of the asset while in the possession of the buyer and the amount by which the value of the asset has decreased as a result of its use by the buyer (or damages for depreciation determined under a similar formula).

190. In these States, a seller that terminates the sale is usually not obliged to account to the buyer for any of the profits made on any subsequent resale of the asset but, at the same time, unless otherwise provided by contract, the seller has no claim against the buyer for any deficiency beyond any direct damages resulting from the buyer's breach of the original sales contract. In some legal systems, courts have also ruled in certain instances that there is an implied term in retention-of-title arrangements that the seller cannot repossess more of the assets sold than is necessary to repay the outstanding balance of the purchase price. Finally, in most of these States, neither the defaulting buyer nor any third party, such as a judgement creditor or a creditor that has taken security on the expectancy right of the buyer in the asset being reclaimed by the seller, may require the seller to abandon its right to recover the assets. As the seller is and always has been the owner of the assets being reclaimed, it cannot be compelled to sell those assets as if it were simply an acquisition secured creditor enforcing an acquisition security right. The only recourses of judgement creditors, secured creditors and other acquisition secured creditors are: (a) if the seller or lessor agrees, to purchase the rights of the seller or lessor (becoming subrogated into the seller's or lessor's rights); or (b) to pay whatever is outstanding under the contract and then exercise their rights on the assets that, as a result, are thereafter owned by the buyer or lessee.

191. The position of a seller that reclaims ownership and possession of assets under a proviso that, having transferred ownership to the buyer, it may retroactively set aside the sale should the buyer not pay the purchase price as agreed (a resolutory condition) is similar to that of the retention-of-title seller. Upon default, the sale is terminated, and the seller reacquires ownership. It may then reclaim possession of the assets as the owner subject to disgorging to the buyer whatever has been paid (discounted in the manner already indicated). In other words, once the resolutory condition takes effect, the rights and obligations of the seller that regains ownership are identical to those of the retention-of-title seller.

192. The situation of the financial lessor is normally slightly different. Since a lease is a contract of continuing performance (the lessee has continuing possession and use while the lessor has a continuing right to payment of the rent), under most legal systems, the lease contract will be terminated for the future only. This result means that the lessee will lose the right to purchase the assets at the end of the lease (or to automatically acquire ownership if the contract so provides), that the lessor will keep the full rental payments received and that the lessee will be obliged to return the assets to the lessor. Subject to any contrary provision in the lease agreement, however, the financial lessor will not be able to claim damages for the normal depreciation of the assets. Damages will be claimable only for waste or extraordinary depreciation. Moreover, unless the lease agreement provides otherwise, financial lessors will not usually be able to claim any shortfall between the amount they receive as rent and the depreciation of the leased assets.

193. Under the unitary approach, the acquisition secured creditor may repossess the assets, as would any other secured creditor. Whether the acquisition secured creditor is a seller, lessor or lender, it will be able, as outlined in the chapter on the enforcement of a security right, either to sell the assets, or if the grantor or other secured creditor do not object, to take the assets in satisfaction of the secured obligation. In the former case, the enforcing creditor will be able to sell under judicial process or privately. Having sold the assets, the secured creditor then has to return to the grantor any surplus on the resale of the assets, but concomitantly has an unsecured claim for any deficiency after the sale (see recommendation 174).

194. If a State adopts the non-unitary approach, several adjustments to existing rules relating to the enforcement of the ownership right of a retention-of-title seller or a financial lessor would have to be made in order to achieve equality of treatment among all providers of acquisition financing. These adjustments could include, for example, giving the buyer or lessee and any secured creditor with a right in the buyer's or lessor's expectancy right, the right to compel a seller or lessor to sell the assets in which ostensibly it has a right of ownership, rather than simply assert that ownership right to regain possession of and ultimately to dispose of the assets. Sellers and lenders with acquisition security rights may propose to take the assets in satisfaction of the buyer's outstanding obligation, but the buyer or other interested party may compel the acquisition secured creditor to sell the assets instead. Achieving full functional equivalence would mean that buyers and other interested parties would be enabled to compel the retention-of-title seller (an owner) to abandon the assertion of its right of ownership and to sell the assets as if it were simply an acquisition secured creditor. It would also require adjusting the seller's or lessor's rights so that they would be required to account for a surplus upon any sale in disposition, while at the same time permitting them to recover as simple contractual claimants for a deficiency without having to bring a separate action in damages.

195. Deficiencies are much more common than surpluses. Still, requiring all providers of acquisition financing (including retention-of-title sellers and financial lessors) to account to the buyer and other creditors with security rights in the expectation right of the buyer for any surplus upon enforcement will encourage those other creditors to monitor the enforcement process closely and thereby enhance the chances that the highest possible value will be achieved. Likewise, providing the provider of acquisition financing with a deficiency claim allows the

creditor to enforce its full claim, which enhances the likelihood of complete repayment. A rule that would deny, absent a contractual term for damages, a deficiency claim to certain providers of acquisition financing (notably retention-of-title sellers or financial lessors), when such a deficiency claim would be enforceable by a seller or lender that exercised an acquisition security right, would be unfair and inefficient. The rights of a seller, especially, should not be significantly different (either to the seller's advantage or to its disadvantage), depending only on whether it chose to retain title or to take an acquisition security right.

196. As a matter of strict legal logic, it is possible to achieve functionally equivalent enforcement results regardless of whether a unitary or a non-unitary approach is adopted. The need for these several adjustments to existing retention-of-title and financial-lease regimes in order to achieve the full benefit of treating all sources of acquisition financing equally, as recommended in the Guide (see recommendation 197), suggests that it may be preferable for States that have not already achieved this coordinated result through legislative, judicial or contractual adjustments to their rules governing retention-of-title rights and financial lease rights to do so by adopting the unitary approach. Nonetheless, the non-unitary approach will, if implemented as recommended in the Guide (see recommendation 197), produce an efficient enforcement regime for acquisition financing transactions.

### 10. Conflict of laws

197. Many legal systems differentiate between rights of ownership arising under a contract of sale or lease and security rights in presenting rules relating to the applicable law. That is, conflict-of-laws rules relating to obligations (for example, not only sales and leases, but also licences and receivables) may differ from those applicable to agreements creating a security right in tangible assets. The treatment of conflicts of laws in relation to security rights in general, and accompanying recommendations, are included in the chapter on conflict of laws. The present discussion only addresses whether retention-of-title rights, financial lease rights and acquisition security rights should be the subject of different recommendations.

198. Notwithstanding the conceptual differences between rights that flow from ownership and security rights, when a retention-of-title right is being used to secure the performance of a payment obligation and possession has been delivered to the buyer, the appearance of the transaction is no different from that where a non-possessory security right is created. Moreover, the asset in question is equally mobile, and is consequently equally likely to cross international borders. As the Guide recommends that lenders may acquire not only security rights, but also acquisition security rights in the expectancy of a buyer, it is possible that once an asset crosses a border and unless the same conflict-of-laws rules are applicable to all such rights, different laws will govern the retention-of-title right and the acquisition security right. Efficiency and transparency of transactions would suggest that this type of conflict should be avoided if at all possible, and that the same conflict-of-laws rules should govern both types of transaction.

199. Under the unitary approach, whether an acquisition financing transaction involves a retention-of-title right, a financial lease right or an acquisition security

right is immaterial for conflict-of-laws purposes. All will be considered as security rights and dealt with accordingly (see recommendation 174).

200. Should a State decide to retain the non-unitary approach, however, it will face the question of whether the conflict-of-laws rules applicable to the creation, third-party effectiveness, priority and enforcement of retention-of-title rights, financial lease rights and similar arrangements should be the same as those that apply to acquisition security rights or, more generally, to ordinary security rights that are taken in the same type of asset. The goal of achieving functionally equivalent outcomes is a powerful argument that States should characterize the ownership rights of retention-of-title sellers and financial lessors as equivalent to acquisition security rights for conflict of laws purposes (see recommendation 199).

### 11. Transition

201. The rules recommended in the Guide relating to the treatment of transactions that in many States were not considered to be security devices represent a significant change for most legal systems. In particular, the characterization of retention-of-title rights and financial lease rights (including rights under hire-purchase agreements) as acquisition security rights will bring about an important modification to the scope of secured transactions law in legal systems that have not already adopted the unitary and functional approach to secured transactions generally. The chapter on transition discusses principles that should govern the transition to the new regime for ordinary security rights as recommended in the Guide. These same principles should regulate the transition in relation to acquisition financing transactions.

202. If a State were to adopt the unitary approach, a smooth transition will depend on attending to the detail of the previous regime governing retention-of-title rights and financial lease rights. For example, if it were already obligatory for retention-of-title sellers and financial lessors to register their rights, then it would only be necessary to provide for a certain delay within which the registration would have to be renewed in the new general security rights registry. Alternatively, the law could provide that the existing registration would remain effective for a sufficiently long time period (e.g. three to five years) to cover the life span of most retention-of-title or financial lease arrangements (see recommendation 228).

203. If no registration of these rights were currently necessary, a smooth transition could be achieved if, consistent with the transition rules applicable to non-acquisition financing transactions, the effectiveness of the rights of retention-of-title sellers and finance lessors against third parties and their priority position were capable of being preserved by registering an appropriate notice in the general security rights registry. Alternatively, the law could provide that the registration requirement would take effect at a date sufficiently far in the future after the new law comes into force (e.g. three to five years) so that it would cover the life span of most retention-of-title and financial lease arrangements existing at the time the new law came into force (see recommendation 228). In order to ensure coherence of the transition, and consistent with the approach taken in the chapter on transition, whatever the length of the transition period that is adopted, it should be the same for rights that had to be registered under prior law, for rights that were exempt from registration under prior law and for non-acquisition security rights.

204. Even if a State decides to adopt the non-unitary approach, in order to establish an efficient secured transactions law, it will be necessary to reorder a number of rules relating to retention-of-title rights and financial lease rights. As the Guide recommends that a notice be registered in the general security rights registry, the same transition rules for registration applicable to the unitary approach could be adapted for the non-unitary approach. As for existing acquisition security rights, the transition should be governed by the same principles as apply to the transition under the unitary approach.

205. In order to put these principles into operation in a manner that produces outcomes that are functionally equivalent to those achieved under the unitary approach, however, various adjustments to the substance of the law relating to retention-of-title rights and financial lease rights would be required. In particular, it would be necessary to determine when the rules relating to the following issues will come into effect: (a) the priority of acquisition financing rights in proceeds; (b) the rights of third parties to acquire security rights in assets subject to a retention-of-title right or a financial lease right; and (c) the procedures for enforcing these types of acquisition financing device including the rights of third parties. While the scale and scope of the needed transition under the non-unitary approach initially might not appear to be as great, the issues that arise in practice will be identical to those arising under the unitary approach and the general principles governing adoption of a unitary regime should also apply to the transition to a reformed non-unitary regime.

### 12. Insolvency

206. One of the central themes of the Guide is that a security right has little or no value to a secured creditor unless it is given appropriate recognition in insolvency proceedings of the grantor. Thus, an effective secured transactions regime must go hand-in-hand with an effective insolvency law. Both are essential to promoting secured credit. For this reason, this Guide goes hand-in-hand with its companion guide, the *UNCITRAL Legislative Guide on Insolvency Law* ("the *UNCITRAL Insolvency Guide*").

207. The general interaction of insolvency law and secured transactions law is addressed in the chapter on the impact of insolvency on a security right. The Guide's recommendations on this topic are in two parts: part A, which reproduces those recommendations of the *UNCITRAL Insolvency Guide* that have a direct bearing on secured transactions, and part B, which is comprised of additional recommendations that are intended to supplement those of the *UNCITRAL Insolvency Guide*. The *UNCITRAL Insolvency Guide* generally defers to non-insolvency law (e.g. a State's secured transactions law) with respect to how a particular acquisition financing transaction is characterized and the legal implications of that characterization.

208. The principle that insolvency law generally defers to non-insolvency law on matters of characterization means that, in States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases will be treated in the grantor's insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* applicable to

security rights would apply to acquisition security rights. Thus, if a State were to adopt the unitary approach, this means that the insolvency law should treat assets subject to an acquisition security right in the same way as assets subject to security rights generally (recommendation 183).

209. A slightly more complicated analysis is required in States that do not treat retention-of-title transactions and financial leases as security devices. Some of these States maintain separately denominated retention-of-title transactions and financial leases but subject them and similar arrangements to the same rules that apply to non-acquisition security rights, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. That is, in these States the ownership of retention-of-title sellers and financial lessors is converted by secured transactions law into a security right when the grantor becomes insolvent. Consequently, the same outcome in insolvency is reached as is achieved in States with fully integrated regimes. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* applicable to security rights will then apply to these transactions, even though under non-insolvency law, they would not be characterized as security rights (recommendation 198, alternative A).

210. Other States that maintain separately denominated retention-of-title transactions and financial leases nonetheless provide for a rough functional equivalence between these rights and acquisition security rights. In these States, retention-of-title transactions and financial leases are treated as assets owned by the seller or lessor. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* relating to third-party-owned assets would then apply to these transactions (see recommendation 198, alternative B).

211. These alternatives can have very different results in insolvency proceedings, especially where reorganization is a possibility. In States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases are treated in the grantor's insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law. In these States, typically the insolvency representative can use, sell or lease the encumbered assets so long as it gives substitute assets to the secured creditor or the value of the secured creditor's right in the property is otherwise protected against diminution. In such situations, any portion of the secured obligations in excess of the value of the secured creditor's right in the property is treated as a general unsecured claim, and in the grantor's reorganization the secured creditor's claim, up to the value of the security right, can be restructured (as is the case with other non-acquisition security rights) with a different maturity, payment schedule, interest rate and the like (see chapter on the impact of insolvency on a security right, paras. […]).

212. The above-mentioned discussion illustrates that in States where retention-of-title transactions and financial leases are not treated as security rights, the insolvency representative often has the right, within a prescribed time period and if willing and able to do so, to perform the contract by: (a) paying the outstanding balance of the price and bringing the property into the estate; or (b) continuing to pay the lease payments as they come due. In some cases, the insolvency representative can assign the contract, together with the right to use the property (which in the case of a lease may require the consent of the lessor) to a

third party. Alternatively, the insolvency representative may be able to reject the contract, return the property and claim the return of the part of the purchase price paid by the buyer subject to a deduction for depreciation and use prior to the insolvency. In the case of a lease, the insolvency representative can repudiate the lease for the future and return the property to the lessor. However, if the property is critical to the success of the buyer's reorganization, only the first option (performance of the contract as agreed) would in practice be available to the insolvency representative. The need for the insolvency representative to perform the contract as agreed may, for example in cases where the current value of equipment is less than the balance of the purchase price, result in other assets of the insolvency estate being used to satisfy that performance rather than being used to fund other aspects of the reorganization of the grantor.

213. In States where assets subject to retention-of-title rights and financial lease rights are treated as third-party-owned assets, the retention-of-title seller and the financial lessor will have stronger rights at the expense of other creditors of the insolvency proceedings. This inevitably will have an impact on the capacity of the insolvency representative to pursue reorganization. As a consequence, States that adopt the non-unitary approach to acquisition financing in non-insolvency situations must also consider whether this characterization of retention-of-title rights, financial lease rights and similar rights should be maintained in insolvency proceedings. The legislative choice is whether encouraging the supply and financing of equipment or inventory by providing special rights for retention-of-title sellers and financial lessors should outweigh insolvency policies that seek to promote reorganization.

## B. Recommendations

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